United States Court of Appeals

for the

District of Columbia Circuit

TRANSCRIPT OF RECORD

JOINT APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18,817

6719

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR., and EDWARD V. OTIS,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR REVIEW OF ORDER OF SECURITIES AND EXCHANGE COMMISSION

CONTENTS

(Securities Exchange Act Release No. 7329)

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.
June 2, 1964

In the Matter of GEARHART & OTIS, INC. File No. 8-2729 Securities Exchange Act of 1934 - Sections 15(b) and 15A	FINDINGS AND OPINION OF THE COMMISSION
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BROKER-DEALER PROCEEDINGS

Grounds for Revocation of Registration

Grounds for Expulsion from Registered Securities Association

Offer, Sale and Delivery of Unregistered Securities

Fraud in Offer and Sale of Securities

Misleading and Inadequate Information in Securities Registration Statement

Where registered broker-dealer offered, sold and delivered unregistered securities and made false and misleading statements in offer and sale of securities concerning, among other things, issuer's financial condition and business prospects, dividends,

and use of proceeds of offering, and registrant's president caused issuer to file registration statement containing misleading and inadequate information, held, in public interest to revoke broker-dealer registration and to expel registrant from registered securities association.

Where registered broker-dealer sold and delivered unregistered securities, made misleading statements in offer and sale of securities concerning, among other things, financial condition, dividends, and prospective operations of issuer, and partner of registrant who was president of issuer participated in preparation of false and misleading offering circular for use by another broker-dealer in offer and sale of securities, held, in public interest to revoke broker-dealer registration.

Where registered broker-dealer, which purchased securities from controlling persons of two issuers with view to distribution, claimed exemptions from registration as to its sales of first issuer's securities on ground, among others, that controlling person was legally required to dispose of shares as condition to serving as official of another company in same industry, and as to its sales of second issuer's securities on ground that such securities were "free" because controlling person had acquired shares from non-controlling persons including persons to whom shares were previously sold by him pursuant to claimed Regulation A exemption, held, claimed exemptions not available because broker-dealer was statutory underwriter, it being immaterial that controlling person had to dispose of his stock to retain employment or that securities may have been exempt from registration prior to acquisition by such person.

APPEARANCES:

Esther Antell, Paul L. Wright, Alan R. Gordon, John Prendergast, and Andrew N. Grass, Jr., for the Division of Trading and Markets of the Commission.

Archibald Palmer and Ralph J. Palmer, of Palmer, Masia & Palmer, for Gearhart & Otis, Inc., Frederick D. Gearhart, Jr. and Edward V. Otis.

Joseph W. Kiernan, of Smith, Ristig & Smith, for McCoy & Willard, William D. McCoy and Alvin Willard.

By WHITNEY, Commissioner:

These are consolidated proceedings under Sections 15(b) and 15A of the Securities Exchange Act of 1934 ("Exchange Act") to determine whether the registrations as brokers and dealers of Gearhart & Otis, Inc. ("G & O") and McCoy & Willard ("M & W"), a partnership, should be revoked; whether G & O should be suspended or expelled from membership in the National Association of Securities Dealers, Inc. ("NASD"), a registered securities association; and whether Frederick D. Gearhart, Jr. and Edward V. Otis, the sole officers and stockholders of G & O, and William D. McCoy and Alvin Willard, partners of M & W, are each a cause of any order of revocation, suspension or expulsion which may be issued. 1/

Following extensive hearings, the hearing examiner recommended revocation of both broker-dealer registrations, expulsion of G & O from NASD membership, and cause findings with respect to the individuals named. Respondents filed exceptions and briefs, our Division of Trading and Markets ("Division") filed a reply, and we heard oral argument. Our findings are based upon an independent review of the record.

G & O or its predecessor has been registered with us as a broker-dealer since 1949, and M & W since 1952. During the period under consideration in these proceedings, Gearhart was president, a director, and 50% stockholder, and Otis was vice-president, a director, and 50% stockholder of G & O, and Willard was managing partner of M & W, while McCoy, who had contributed most of its capital, devoted his time largely to other business activities. At the end of 1955, the partnership ceased doing business and was dissolved, but it did not withdraw its registration.

These proceedings involve alleged willful violations by respondents of the registration provisions of the Securities Act of 1933 and the anti-fraud provisions of that Act and the Exchange Act in connection with the sale of securities of Air America, Inc. Additional allegations are that the G & O respondents willfully violated the registration provisions of the Securities Act in connection with the sale of securities of National Lithium Corporation and American States Oil Company. Gearhart is further charged with a willful violation of Section 7 of the Securities Act in causing National Lithium to file a registration statement containing misleading and inadequate information.

1/ G & O and its officers are hereinafter collectively referred to as the "G & O respondents," and M & W and its partners as the "M & W respondents."

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AIR AMERICA, INC.

Violations of Registration Provisions

Air America was a non-scheduled airline providing coast-to-coast coach flights. In October 1952, its president, Fred A. Miller, resigned to become president of another airline company. Under applicable law, he was required to divest himself of his controlling stock interest in Air America, which consisted of 892,500 shares, or about 77% of the outstanding stock. Because of the absence of a market for a block of that size, Miller in November 1952 transferred his shares to McCoy as trustee under a trust agreement which provided for an orderly liquidation of the shares within a reasonable time. In the interim the trustee was to have "all the rights . . . normally incident to . . . legal and equitable ownership," including the right to vote such stock.

Notwithstanding these provisions, McCoy looked to Miller for instructions regarding sales of the stock and the terms of sale. In January and February 1953, pursuant to Miller's instructions, McCoy disposed of 222,500 shares, consisting of 165,000 shares sold to G & O, 45,000 shares transferred to one Nathan S. Kohn, and 12,500 shares transferred to an attorney for legal services to be rendered to Air America.

Of the 165,000 shares purchased by G & O, a total of 138,500 shares were immediately resold to M & W. Willard in turn sold them to about 43 persons. Although the shares were initially registered in the names of only 15 persons, who gave Willard letters stating that their purchases were made for the purpose of investment and not for resale, Willard knew of and was to a large extent responsible for an arrangement whereby the shares purportedly purchased by three of these persons included shares acquired on behalf of about 28 additional persons and later transferred into their names. A number of the additional persons who acquired stock through one of the record purchasers were strangers to him.

G & O also sold 20,000 shares to Kohn and 6,500 shares to McCoy in January 1953. Kohn furnished an "investment" letter, but his purchase was in fact made for a group consisting of himself and four other persons. In March 1953, G & O repurchased 5,000 of the shares which had been sold to the Kohn group and disposed of them in the open market. G & O also participated in the distribution of shares acquired from McCoy by Kohn on his own behalf and by the attorney. Thus, in February 1953 it purchased the attorney's 12,500 shares and resold them, and between March and June 1953, it purchased 15,900 of the Kohn shares which it also resold.

Respondents contend that they did not violate Section 5 in connection with these transactions, and that any such violation was not willful. G & O argues that it was not an underwriter within the definition in Section 2(11) of the Securities Act, 2/ and that its sales were therefore exempt from registration under Section 4(1) of the Securities Act. Without expressly raising the question whether Miller, or McCoy as trustee, was a controlling person of Air America, G & O contends that its sales did not constitute a distribution or public offering, since the purchasers were persons who did not require the protection of that Act, and that G & O did not "participate" in any underwriting by M & W, within the meaning of Section 2(11). It asserts that although it knew that M & W intended to resell the shares, Gearhart told Willard to limit sales to a small group of persons taking for investment and G & O did not anticipate that sales to more than 15 persons would be made. With respect to the shares purchased by G & O from Kohn and the attorney, G & O urges that this was "free" stock not required to be registered. Finally, it urges that consideration must be given to the fact that the sale of Miller's stock was legally required.

M & W contends that it likewise was not an underwriter, and that its sales therefore were also exempt under Section 4(1). Its argument is predicated principally on the assertion that neither Miller nor McCoy was in control of Air America after Miller placed his shares in trust and that therefore M & W's purchase of 138,500 shares from G & O and the resale of such shares did not constitute participation in any distribution by an "issuer" within the meaning of Section 2(11).

In our opinion, respondents have failed to sustain their burden of proving that their 1953 transactions were exempt from

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2/ Section 2(11) defines an "underwriter" in part as

> "Any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking."

For purposes of Section 2(11), the term "issuer" is defined to include "any person directly or indirectly controlling the issuer."

registration, 3/ and the evidence amply supports the hearing examiner's conclusion that both respondent firms were underwriters with respect to those transactions. 4/

The hearing examiner found that, notwithstanding the trust agreement, Miller, at least for some months, continued to exercise an important voice in Air America's affairs. However, apart from the question whether Miller continued to be a controlling person, the sales effected by McCoy during 1953 pursuant to his obligation under the trust agreement were merely steps in a process of distribution which Miller initiated with the execution of that agreement and in which respondents participated. To hold otherwise would permit easy evasion of the registration requirements by controlling persons.

The sale by M & W of 138,500 shares to more than 40 persons, who were not shown to have access to the kind of information which registration would disclose, clearly constituted a distribution. 5/ The argument that G & O was not an underwriter because it sold to persons who did not themselves need the protection afforded by registration is clearly without merit, since, as Gearhart knew, M & W acquired the 138,500 shares from G & O not for investment, but for resale. Even if, as claimed, Gearhart told Willard to limit sales to a small number of purchasers, there is no evidence that he similarly instructed Willard to limit the number of offerees. And even

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3/ Exemptions from the general policy of the Securities Act requiring registration are strictly construed against the claimant of such an exemption and the burden of proof is on the claimant. See S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953); S.E.C. v. Sunbeam Gold Mines Co., 95 F.2d 699 (C.A. 9, 1938); Gilligan, Will & Co. v. S.E.C., 267 F.2d 461 (C.A. 2, 1959), cert. denied 361 U.S. 896; S.E.C. v. Culpepper, 270 F.2d 241 (C.A. 2, 1959).

4/ See S.E.C. v. Chinese Consolidated Benevolent Association, Inc., 120 F.2d 738 (C.A. 2, 1941), cert. denied 314 U.S. 618; S.E.C. v. Culpepper, supra. These cases also stand for the proposition that persons who engage in steps necessary to the public distribution of shares by an issuer cannot invoke the exemption provided by Section 4(1) of the Securities Act, even if they do not come within the definition of "issuer, underwriter, or dealer."

5/ See S.E.C. v. Ralston Purina Co., supra; S.E.C. v. Sunbeam Gold Mines Co., supra; Op. Gen. Counsel, Securities Act Release No. 285 (January 24, 1935).

assuming that G & O did not anticipate that M & W would make offers or effect sales to more than 15 persons and recognizing that a limited number of offerees is a factor to be considered in determining whether a distribution within the meaning of Section 2(11) is involved, 6/ G & O, by selling a large block of securities to a broker-dealer, who it knew would resell them to public investors, assumed the risk of offers to more than 15 persons and of a larger distribution than it might have anticipated. 7/

In addition, G & O further enlarged the group of purchasers through its sales to the Kohn group and McCoy, its reacquisition and sale of a portion of the Kohn group's shares, and its purchase and resale on the open market of the shares which Kohn and the attorney had acquired directly from McCoy. There is no basis for the contention that the shares purchased from Kohn and the attorney constituted "free" stock not required to be registered. Those individuals acquired the stock with a view to distribution, and in any event, the transactions must be viewed as part of the public distribution of Miller's shares. Gearhart admittedly knew the source of the attorney's stock; and while he disclaimed any knowledge of the transaction whereby Kohn obtained 45,000 of the Miller shares from McCoy, the large amounts involved in the sale to G & O should have put him on notice regarding their source. 8/

Respondents are not aided by the fact that Miller was required to divest himself of his controlling interest in Air America because he wished to be an officer of another airline company. This requirement could not obviate the need for compliance with the registration requirements of the Securities Act.

6/ As early as 1934, the General Counsel of the Commission, in a widely circulated opinion, had stated that "In no sense is the question /of what constitutes a public offering/ to be determined exclusively by the number of prospective offerees." See Securities Act Release No. 285 (January 24, 1935), which quotes the opinion of the General Counsel.

7/ See Elliott & Company, 38 S.E.C. 381 (1958). This is particularly so in light of the size of the individual investment which would be required if the limitation were adhered to.

8/ While Gearhart testified that Kohn assured him this was "free" stock, he could not properly rely on the latter's self-serving declaration in these circumstances.

The mails and facilities of interstate commerce were used by registrants in connection with the sale and delivery of the Air America shares. Accordingly, we find that respondents violated the registration provisions of Sections 5(a)(1) and 5(a)(2) of the Securities Act.

Respondents, in support of their contention that any such violations were not willful, assert that they relied in good faith on the advice of counsel, and that, in view of the then prevailing understanding of the so-called private offering exemption, such reliance was clearly justified. Recognizing that this defense would not negate a finding of willfulness within the meaning of Section 15(b) of the Exchange Act as interpreted by us, 9/ they urge us in effect to reconsider and modify such interpretation. They argue that willfulness, as defined by the courts, connotes at a minimum conduct marked by a careless disregard of whether it is lawful. They point out that even in Hughes v. S.E.C., 10/ which has been frequently cited in Commission decisions on the question of willfulness, the respondent had been repeatedly advised by our staff prior to the institution of proceedings that her methods of doing business were unlawful.

We have consistently held and it has been judicially established in broker-dealer proceedings that if a respondent acts intentionally in the sense that he knows what he is doing, his action is willful, and that there need not be in addition an intent to violate the law. 11/ We have never considered a careless disregard of the law to be necessary for a finding of willfulness. That such a situation has been found to constitute willfulness or that, as in the Hughes case, the conduct of a respondent who deliberately chose to continue a method of operation in spite of repeated warnings that it was unlawful was found willful, does not mean that either situation is the

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9/ See Thompson Ross Securities Co., 6 S.E.C. 1111, 1122-23 (1940); The Whitehall Corporation, 38 S.E.C. 259, 270 (1938); Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 854-55 (1959). Such reliance, however, has been taken into consideration in determining the nature of the sanction, if any, to be imposed in the public interest.

10/ 174 F.2d 969, 977 (C.A.D.C., 1949).

11/ See Thompson Ross Securities Co., supra; Van Alstyne, Noel & Co., 22 S.E.C. 176 (1946); The Whitehall Corporation, supra; Hughes v. S.E.C., supra; Norris & Hirschberg, Inc., v. S.E.C., 177 F.2d 228, 233 (C.A.D.C., 1949); Shuck v. S.E.C., 264 F.2d 358, 363 (C.A.D.C., 1958).

minimum required for such finding. In U. S. v. Murdock, the Supreme Court stated that "The word /'willfully'/ often denotes an act which is intentional, or knowing, or voluntary, as distinguished from accidental. *** Aid in arriving at the meaning of the word 'willfully' may be afforded by the context in which it is used . . ." 12/ The remedial purpose of Section 15(b) would be frustrated if we were required to interpret willfulness in the narrow manner urged by respondents. 13/

In February 1954, pursuant to a settlement of certain litigation between Air America, Miller, and others, McCoy as trustee and Miller, who had claimed he revoked the trust and reacquired title to the shares of Air America remaining in the trust, agreed to and did sell 345,000 of those shares to G & O and M & W. Also, pursuant to the above settlement, Miller assigned an additional 250,000 of those shares to Air America, which sold them to G & O. The 345,000 shares were then also purchased by G & O. Within a matter of days, G & O sold a total of 430,000 shares, of which 135,000 shares were purchased by M & W, 255,000 by G. Everett Parks, the president of another broker-dealer, 10,000 by Kohn and 30,000 by another customer.

In February and March 1954, Willard, who had been told by Gearhart that in selling the shares he could "go up to eight names," resold 100,000 shares on behalf of M & W to a total of six customers, who had also purchased shares from M & W in 1953 and five of whom submitted investment intent letters.

Parks' purchases of 255,000 shares were effected in several transactions, and he furnished an investment intent letter for each transaction. However, in two such letters he instructed G & O to register the stock in the name of one of his friends, and he immediately resold a total of 168,000 shares

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12/ 290 U.S. 389 at 394, 395 (1933).

13/ The record discloses that respondents' counsel rendered his advice on the basis of assurances that the shares would be offered to not more than 15 persons taking for investment. However, respondents should have been aware that in attempting to sell a large block of stock to a limited group of persons, offers to sell would as a practical matter have to be made to a larger group, and in fact, as we have found, the shares were offered and sold to substantially more than 15 persons. Moreover, counsel's advice, and therefore presumably the information given him, did not relate to G & O's subsequent transactions in the stock acquired by Kohn and the attorney directly from McCoy. Under these circumstances, respondents cannot appropriately claim "good faith" in relying on their counsel's advice.

to that friend and five other friends, each of whom represented to Parks that he was purchasing for investment only. Parks sold an additional 50,000 shares to six customers of his firm through salesmen of that firm and four of such customers signed investment intent letters. These latter sales were cancelled because Parks "felt that it might be construed as a public offering if I used any salesmen."

We conclude that the 1954 sales also constituted an unlawful distribution. Of the 595,000 shares acquired by G & O in this series of events, 250,000 were acquired from Air America, the issuer, and the remaining 345,000 clearly constituted either a control block standing alone or a part of a larger control block of 595,000 shares. 14/ It is clear that G & O acquired the entire block of 595,000 shares with a view to resale; that the circumstances of its sales of 430,000 of these shares, and the resales by the persons purchasing from G & O, were such as to compel the conclusion that G & O and M & W participated in a distribution of the shares; and that G & O and M & W were, therefore, underwriters within the meaning of Section 2(11) of the Securities Act and not entitled to the exemption afforded by the first clause of Section 4(1). On the record before us, G & O and M & W, with respect to these 430,000 shares, cannot treat separately the various sales made by them nor even the resales made by Parks. Furthermore, neither the fact that the ultimate purchasers of these shares were limited in number, 15/ nor that in certain cases they already were Air America stockholders, 16/ is in itself sufficient to entitle respondents to the benefit of the exemption provided by the first clause of Section 4(1). Accordingly, we find that in the sale of 430,000 shares of Air

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14/ It is not necessary to determine specifically whether Miller or McCoy or both were the controlling persons with respect to the 595,000 shares at the time they were transferred to the issuer and G & O pursuant to the settlement.

15/ S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953); Gilligan, Will & Co., 38 S.E.C. 388 (1958), aff'd 267 F.2d 461 (C.A. 2, 1959), cert. denied 361 U.S. 896; Rock Frederick Houle, 39 S.E.C. 821, 823, n. 9 (1960); D. F. Bernheimer & Co., Inc., Securities Exchange Act Release No. 7000, p. 5-6 (January 23, 1963).

16/ S.E.C. v. Sunbeam Gold Mines Co., 95 F.2d 699 (C.A. 9, 1938).

America stock in 1954, respondents willfully violated Sections 5(a)(1) and 5(a)(2) of the Securities Act. 17/

Violations of Anti-Fraud Provisions

The orders for proceedings alleges that between January 1953 and March 1954 respondents made misrepresentations in the offer and sale of Air America Series B equipment trust certificates and common stock.

1) Background

In 1951, an issue of $290,000 of Air America Series A equipment trust certificates, secured by two of the four planes owned by Air America, was sold through G & O as underwriter. These two planes, legal title to which was transferred to a trustee, were "leased" to Air America by the trustee at a "rental" sufficient to pay the certificates and dividends thereon and were in turn leased by Air America to other carriers. The other two planes were operated by Air America itself. As of January 1953, all or substantially all functions necessary to Air America's operations, including the sale of tickets, the furnishing of crews, the keeping of its books, and the collection and disbursement of funds, had been sub-contracted to other concerns. Thus, Airline Tickets, Inc. ("Tickets") and two affiliated companies, which operated ticket offices in various cities,were ticket agents for Air America, while other affiliates performed the other functions.

Aside from its airplanes, Air America's principal asset consisted of accounts receivable, of which sums due from Tickets for tickets sold on Air America flights constituted the largest part. A balance sheet as of June 30, 1952 showed total accounts receivable of $171,875, including $122,497 due from

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17/ Respondents used the mails in the sale and delivery of the shares involved. The hearing examiner properly rejected, as not supported by the record, respondents' claim that Miller had obtained Commission approval for the 1954 sales. While Miller made reference in his testimony to a letter forwarded by an official in our New York Regional Office to our principal office "for approval," respondents did not produce any letter on this subject and there is nothing in the record concerning the contents of any such letter. We also note that neither Gearhart nor Willard, in testifying with respect to the 1954 transactions, claimed that Commission approval had been obtained.

Tickets and $6,250 due from the affiliated ticket agencies. 18/ By the end of 1952, accounts receivable, as reflected in an unaudited balance sheet, had reached almost $394,000. 19/ As discussed below, the first quarter of 1953 saw a further substantial increase in this item.

As the year 1953 began, the management of the company and others closely associated with it were optimistic regarding its future prospects, an optimism predicated to a large extent on the anticipated grant of an application filed with the C.A.B. early in January 1953 for permission to operate coast-to-coast coach flights on a regular basis. In fact, no action was ever taken on this application. Instead of favorable developments, the year brought an almost continuous financial crisis, and by early 1954 Air America was insolvent and had for all practical purposes ceased doing business.

The principal direct cause of the company's failure was its inability to secure any substantial payments on the sums due from the ticket agencies. These sums included amounts collected by the agencies for federal transportation taxes. As a result of the non-payment of these and other taxes totalling more than $180,000, the two planes which were operated by Air America were seized by the Internal Revenue Service in April 1953 and remained grounded until the bulk of the delinquent taxes was paid more than a month later. Air America had considerable difficulty in obtaining the necessary funds. It was able to obtain $27,900 from the Series A sinking fund because of the conversion by various holders of a number of certificates into common stock. After unsuccessful efforts to obtain the balance from the ticket agencies or through a bank loan, Air America was finally able to obtain a loan of $138,800 from Sunderland Corporation in May 1953, in return for a 90-day note for $147,800 secured by a chattel mortgage on the two planes and G & O's guarantee of repayment. The tax lien was then discharged with the proceeds of the loan, the $27,900 from the sinking fund, and more than $8,000 advanced by McCoy personally.

Funds were now needed to repay the Sunderland loan. To this end, as well as to obtain working capital, Air America, through G & O as underwriter, commenced a public offering of

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18/ The auditors noted, however, that $165,645 of the accounts receivable was not confirmed by the debtors because of lack of current information, and stated that they were precluded from rendering an opinion for this reason.

19/ The financial statements as of that date do not include a breakdown of the accounts receivable.

$300,000 of Series B equipment trust certificates pursuant to Regulation A in June 1953. However, following objections raised by our staff to the contents of the offering circular, as amended, the offering was terminated after only half the certificates had been sold. Of the proceeds of the offering, $100,000 was paid to Sunderland Corporation on account of the loan and one of the planes was discharged from the mortgage and placed under the equipment trust. When the balance of the loan matured in August, Air America was unable to pay it, and toward the end of the year the mortgage remaining on one plane was foreclosed. In the meantime, Air America also defaulted on the required monthly payments under the Series A and Series B trusts in September and October 1953, respectively. The trustee subsequently took possession of the three planes subject to the trusts, and they were sold during 1954 and 1955.

Following unsuccessful efforts to collect amounts due or even to obtain an agreement for payments on a regular basis, Air America in September 1953, instituted suit against Tickets and its affiliates, their record owner, Don Rich, and Miller, who was alleged to be a co-owner of those companies and to have conspired with Rich to divert to their own use funds due from the ticket agencies to Air America. This action culminated in a settlement in February 1954, including a consent judgment against Tickets and one of the affiliates for $300,000, which was never paid, and the transfer by Miller of 250,000 shares of Air America stock to Air America. As we have seen, these shares were then acquired by G & O. In December 1953, in proceedings which had been instituted in 1952, the C.A.B. revoked Air America's letter of registration to operate as a common carrier for violations of C.A.B. regulations.

This outline of Air America's history during the relevant period is substantially undisputed. The issues raised by the allegations of fraud revolve largely around the question whether, in the light of the facts referred to and others, and the inferences to be drawn from them, certain representations made in the Series B certificates offering circular and in the sale of Air America common stock regarding the company's financial condition and related matters were materially false or misleading.

2) Series B certificates

(a) Accounts Receivable

The major deficiency in the Series B offering circular, as amended, was the failure to disclose the precarious financial condition of Air America stemming from the problems involved in collecting the debts represented by the accounts receivable item listed as a current asset in an unaudited balance sheet as of

March 31, 1953, included in the offering circular. That balance sheet listed total assets of about $888,000 and current assets of about $630,000, including accounts receivable of $627,905. Of the total receivables, $516,866 represented amounts due from Tickets, of which $393,405 was more than 90 days old.20/The next largest component of the receivable was $45,611 due from Caribbean American Lines, Inc. ("Caribbean") on a lease of a plane from Air America.

While the financial statements included in the offering circular showed that Air America had no cash and in fact was overdrawn to the extent of about $1,000, there was no indication in the circular, at least until it was amended on June 26, 1953, by which time substantially all of the sales had already been made, that since April 1953 Air America had been faced with constant crises in meeting its obligations, particularly its tax obligations. Nor was there any disclosure that, because of the company's shortage of funds, dividends paid on May 1 and June 15 had been paid with funds advanced by G & O respondents, M & W and Miller, and that the May 1953 "rental" under the Series A certificates was not paid until after the due date and was then paid with funds advanced by G & O. The June 26 amendment stated that the two planes had been seized for unpaid taxes and then released when these taxes were substantially paid with funds derived principally from a loan, and this information was incorporated in the final circular dated June 30, 1953. However, the critical nature of Air America's financial condition was not adequately disclosed.

The only indication in the offering circular that there might be some problem regarding the collectibility of the accounts receivable was a note to the accounts receivable item in the last three amended circulars, to the effect that Tickets claimed additional commissions of $88,000 and that, to the extent this claim was agreed to by Air America or adjudged valid, the receivables would be reduced. This comment, if anything, tended to convey the impression that there was no question regarding the balance of the item. This impression did not accord with the facts. The record shows that by April or at the latest May 1953, it had become quite apparent that there was a serious question whether a substantial portion of the amounts due from Tickets and Caribbean could be collected at all, let alone

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20/ Apparently, under the accounting system used, the $516,866 figure included the amount due from Tickets' affiliated ticket agencies.

within a year, and that the company's management and others involved in its affairs, including Gearhart, were greatly concerned regarding the collectibility of these receivables. 21/

The awareness by the principals of the serious financial problems faced by Air America was reflected in an exchange of letters in April 1953, prior to the plane seizure, between McCoy, then chairman of the board of Air America, and Russell E. Randall, Miller's successor as president. McCoy, in requesting Randall's resignation, stated that he intended to "assume responsibility for the successful rehabilitation of the finances of Air America, Inc. Air America is not by any means insolvent but it requires that its present financial condition be determined and adjusted and that future financial operation of the company be more closely supervised." Randall in his letter referred to "irregular and improper methods" employed in the conduct of Air America's business, and stated that Rich was in effect running the business, and that the latter's actions had been the direct cause of Air America's "poor financial position." Randall further stated that "it is believed that many of /the large receivables/ are not good indicating that the financial situation of the company is not good."

The seizure of the planes for non-payment of taxes brought Air America's financial problems to a head. As noted, $27,900 was obtained from the Series A sinking fund, and was applied toward payment of the tax liability. Aside from this amount, the company had practically no funds when McCoy replaced Randall as president on April 30, and Tickets could raise only about $10,000. At the directors' meeting of April 30, it was resolved that the executive committee explore all possibilities of effecting prompt collection of the accounts receivable from the ticket agencies. McCoy then arranged to meet with Miller, Rich and Gearhart on May 7 for the purpose of either obtaining a substantial payment on account of the receivables or acquiring from Rich and Miller some collateral which Air America could use to obtain needed funds. 22/ M & W respondents

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21/ It is immaterial, in this connection, whether the collection problems with respect to Tickets were attributable, as claimed, to an unauthorized diversion of funds, or to business adversity or other causes, as long as these problems could reasonably be anticipated.

22/ The above represents McCoy's testimony regarding the origin and purpose of the meeting. Gearhart's version of the meeting is that he "forced" Miller and Rich to meet with him and McCoy and requested them to bring collateral in the form of

(Continued)

assert that this meeting greatly encouraged McCoy and Gearhart, because both Rich and Miller expressed their confidence regarding Tickets' ability to liquidate the indebtedness and Rich indicated his willingness and desire to do so. However, there was no reasonable basis for optimism.

Neither objective of the meeting was achieved. Rich stated that the ticket agencies had no funds presently available beyond necessary operating funds, and all that McCoy was able to accomplish by way of obtaining collateral was an agreement by Miller to advance 250,000 shares of Air America stock. However, the terms of the agreement as subsequently formalized were that the stock would not be disposed of unless Tickets "defaults" on its obligations to Air America, 23/ and it therefore did not provide a means for Air America to obtain funds. Moreover, even as collateral this stock was of little value, since it would be substantially worthless if Tickets failed to pay the amount owed to Air America.

The asserted ability of Tickets to discharge its indebtedness was predicated on the assumption of a good summer business season, rather than on any existing availability of funds. 24/ McCoy, while disclaiming any doubts until much later

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22 contd./

stock of a manufacturing company they owned, and that at the meeting Miller and Rich agreed to provide this stock, but then failed to comply with the agreement. He further testified that he asked for security because he was concerned about the size of the receivable from Tickets, and did not know whether it was collectible.

23/ Since the obligations were overdue and Air America was then pressing for payment, the type of situation that would constitute a default under the agreement is not clear.

24/ Both McCoy and Gearhart attempted, prior to the Series B offering, to obtain financial statements of Tickets. However, these efforts were unsuccessful, apparently because Tickets' books were not up-to-date. The ignorance of Air America regarding the financial condition of its principal debtor should itself have been reflected in Air America's financial statements. A balance sheet for Tickets as of March 31, 1953, prepared subsequent to the Series B offering, showed that the company was insolvent on that date. Tickets and its affiliated agencies ceased doing business at or about the end of 1953.

regarding the collectibility of the receivables, admitted that he was concerned whether the forthcoming summer business would be as good as in the previous year and that if a good season did not materialize there might be "serious ramifications." In fact, the "good" season, which was expected to begin in May, failed to materialize as a result of increased competition from the scheduled airlines in the coast-to-coast coach business and the bad publicity and cancellations of reservations resulting from the seizure of the two planes. Moreover, one of the two planes operated by Air America was grounded for almost a month during June and July for a periodic inspection and overhaul.

Finally, Rich did not commit the ticket agencies to making regular payments, but merely stated that he thought each of the three agencies would be able to pay $10,000 a month beginning in June, when the good season was expected to start. On that basis, it would have taken about one and a half years to liquidate the receivables then due, assuming that payments would continue during the slow season.

The M & W respondents also stress the fact that at the May 7 meeting Rich agreed to have representatives of Air America stationed at the various ticket agencies to collect the proceeds when the tickets were used. However, one such representative testified that McCoy told him that the need for such an arrangement existed because of Rich's "constant vacillation." That background was hardly one to inspire confidence in Rich's assurances that the obligation would be paid. The scepticism manifested by McCoy was borne out when Rich, in early June, abruptly terminated the arrangement for on-the-spot collection from the ticket agencies. Then came further efforts, at or about the time of the Series B offering, to obtain new agreements with the ticket agencies, which would assure immediate collection following the use of tickets as well as regular payments on past indebtedness. 25/ These negotiations continued into August or September 1953 and then collapsed. In September, as previously noted, Air America cancelled its contracts with the ticket agencies and instituted the action to collect the indebtedness, which resulted in recovery of only a small fraction of the total amount due.

25/ A letter dated July 1, 1953 from an attorney for Air America to McCoy, enclosing drafts of proposed new agency agreements and of related agreements containing an acknowledgment of indebtedness and a plan for payment, stated, "I have advised you that you should secure the guarantee of performance individually from Don Rich. Without this it is problematical if you can rely upon the agreement because of the uncertainty and results of the operation of the ticket offices."

Caribbean was in arrears on the rental payments due on the plane leased from Air America. On April 30, 1953, Air America's board of directors voted to cancel the lease "immediately, or as soon as possible" and it was in fact cancelled. McCoy was unable at that time to determine the amount due because Air America's books were not posted to date. He inquired from Rich regarding the prospects of collection and was informed that Caribbean did not have the funds to pay the amount due, but that payment would be made "as soon as the season opened up." However, no specific commitments were made and McCoy admitted that, aside from the plane leased from Air America, Caribbean's assets consisted of one other leased plane, and that it owed more in taxes than Air America. Thus, the prospect of collection from that company was dim, to say the least.

We conclude that the accounts receivable from Tickets and Caribbean were of doubtful collectibility; that at best the collection of these receivables could be effected only over an extended period; and that the company's management and Gearhart were seriously concerned about these matters. Under these circumstances, the inclusion of the total amount of the receivables in current assets and the failure to disclose Air America's actual financial condition made the offering circular materially misleading.

The M & W respondents assert that the extent of the disclosure required in a Regulation A offering is more limited than that in a registered offering. However, regardless of the scope of the information which is required to be furnished, an offering circular may not include false or misleading information. Moreover, as these respondents themselves point out, Rule 219 of Regulation A in effect at the time of the Series B offering required that the offering circular include "appropriate financial statements" showing "the issuer's financial condition as of a date within 90 days prior to filing the notification." It is apparent that the financial statements did not reflect the issuer's true financial condition.

(b) Use of Proceeds

The offering circular also contained false and misleading information regarding the intended use of the proceeds of the offering.

The circular stated that if the offering were completely sold, the net proceeds, after payment of the underwriters' commission, counsel fees, and expenses, would be used first to discharge debts totalling $165,800 which were secured by mortgages on the two planes operated by Air America, and the balance would be used as working capital. It was further

stated that in the event a lesser amount of the offering, but no less than $150,000 of certificates, were sold, only $150,000 of certificates would be issued and Air America would add to the net proceeds a sufficient amount to discharge the entire indebtedness. However, when it became apparent that the offering could not be completed and that Air America would be faced with the necessity of supplementing the proceeds of the offering in order to pay the indebtedness in full, arrangements were made with the mortgagees to obtain the discharge of only one plane from the liens upon payment of part of the indebtedness. Out of the net proceeds of $135,000, the two mortgagees were paid $100,000 and $10,000, respectively, and released their liens on one of the planes. Of the remaining proceeds, approximately $10,000 was divided among G & O, Gearhart, Otis, M & W and Miller to reimburse them for their dividend advances.

There is no indication in the record that certificate purchasers were specifically alerted to the fact that, contrary to the representation in the offering circular, the liens were not to be discharged in full upon termination of the offering.26/ The failure to inform purchasers of the significant departure from the previously disclosed plan with regard to payment of the plane indebtedness rendered the offering circular materially misleading. Moreover, the representation that in the event less than the total amount of the offering were sold, Air America would make up the difference between the net proceeds and the total indebtedness to the mortgagees was misleading if not false. It is clear, in the light of what has already been said, that Air America was in no position to provide such differential, which would have amounted to more than $30,000.

Finally, the failure to disclose that a portion of the proceeds would be diverted to repayment of the dividend advances also rendered the offering circular false and misleading.

26/ A sticker was attached to the copy of the final offering circular of June 30 filed with us stating that if the mortgagees agreed to release one of the two planes upon payment of less than the full amounts owing to them, Air America would not have to discharge the entire indebtedness at that time. However, all the certificates were sold on or before June 30, and the record indicates that an amended offering circular ante-dating the June 30 circular was used. While a number of purchasers also received the June 30 circular, it is not clear whether the sticker was in fact attached, and in any event the record indicates that at least a few purchasers did not receive such circular.

(c) Tax obligations on planes

We also agree with the hearing examiner's finding that the last two amended offering circulars were false and misleading in stating that Air America had added to the proceeds of the loan from Sunderland, amounting to $138,800, an amount sufficient for Air America to pay approximately $147,500 toward the tax obligation of about $155,500 due on May 25, 1953. 27/ The tax liability originally totalled about $184,000. While Air America had previously made a payment which reduced that liability to about $155,500, the amount subsequently added to the proceeds of the Sunderland loan represented funds advanced by McCoy personally, and not company funds. While it is true, as respondents point out, that our rules in effect at the time of the offering did not specifically require information regarding advances to an issuer by its officers, they did require that statements made not be false or misleading. In the context of this case the statement was significantly false and misleading, since it tended to compound the misleading picture of Air America's financial condition presented in the financial statements.

(d) Conclusion

Both Gearhart and Otis were personally active in the sale of the certificates. Contrary to his disclaimers, Gearhart was not only intimately familiar with all significant developments relating to Air America, but participated in many of the major decisions and actions involving that company, including his advance of funds to Air America for the payment of dividends, which created the false impression that the company was financially able to pay dividends. Gearhart's awareness of the serious questions regarding the collectibility of the receivables has been previously discussed. Significantly, he testified at one point that he instructed the attorney who prepared the offering circular to add a footnote to the accounts receivable item to the effect that "we were not positive of the collectibility of those accounts," so that purchasers of the certificates "would know the facts." In further testimony, he denied that he had suggested the inclusion of such a footnote, but stated that he had discussed the matter with the attorney

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27/ The G & O respondents urge that since this language appeared for the first time in the amended offering circular dated June 26, when virtually all sales had already been effected, no investors could have relied on it. However, as previously indicated, it appears that the final June 30 circular was delivered to at least some of the purchasers.

and had "heard that such a notation was made." Gearhart also knew that McCoy had advanced funds toward the payment of Air America's tax obligations. Otis was treasurer and a director of Air America beginning about April 30, 1953. Although he did not take an active part in its management, he did perform various functions in connection with the payment of dividends, including the opening of an account in his own name into which the dividend advances by him and the others were deposited and from which dividend payments were made, and the issuance of Air America checks in repayment of those advances after Air America received the proceeds from the offering of the certificates.

Aside from the circumstances known to these respondents as a result of their involvement in Air America's business, G & O, as the underwriter, and its principals owed a duty to the investing public to exercise reasonable care to assure the substantial accuracy of the offering circular. 28/ This they failed to do. 29/

Under the circumstances, we find that by using the offering circular in the offer and sale of Series B certificates, G & O, together with or aided and abetted by Gearhart and Otis, willfully violated Section 17(a) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act and Rules 17 CFR 240.10b-5 and 17 CFR 240.15c1-2 thereunder. 30/

McCoy, in his capacity as president of Air America, played a leading role in the preparation of the offering circular and was obviously aware that G & O, the underwriter, would use that circular to sell the Series B certificates and would, in the ordinary course of business, use the jurisdictional facilities to do so. Under these circumstances, we are of the view that he willfully violated and aided and abetted G & O's

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28/ See Charles F. Bailey & Company, 35 S.E.C. 33, 41-42 (1953); Heft, Kahn & Infante, Inc., Securities Exchange Act Release No. 7020, p. 4-5 (February 11, 1963); The Richmond Corporation, Securities Act Release No. 4584, p. 7-9 (February 27, 1963).

29/ Otis' disregard of his responsibilities is reflected in his own testimony that he "probably glanced through" the offering circular and "paid very little attention" to it; that he left it "to the lawyers" to prepare material of this nature; that he could not recall reading a draft of the offering circular which the attorney had sent to him and Gearhart with instructions to read carefully and to inform him of any corrections; and that he made no inquiries into Air America's financial condition.

30/ The mails were used in connection with these transactions.

willful violations of the anti-fraud provisions. 31/ While Willard, on behalf of M & W, offered certificates for sale, there is no evidence regarding either his use of the offering circular in that connection or the nature of any representations he may have made, and accordingly we make no adverse findings as to M & W or Willard in this respect. However, since McCoy was a partner of M & W until the firm was dissolved, his participation in the violations provides, pursuant to Section 15(b) of the Exchange Act, a basis for disciplinary action against M & W.

3) Common Stock

(a) G & O and Gearhart

In connection with the sale by G & O of Air America stock to a retail broker-dealer in late June or early July 1953, Gearhart conveyed to him materially misleading information which the latter in turn used in selling the stock to his customers. Gearhart told the dealer, who requested information with a view to trading in the stock, that Air America was paying a dividend of 1¢ per share a month, was earning enough to double that dividend, and was planning to expand its operations. In response to the dealer's request for information to be used in preparing a report on Air America, Gearhart gave him a Series B offering circular and a copy of a March 1953 letter from Randall, who at that time was president of Air America, announcing to stockholders a decision to pay a monthly dividend beginning May 1 "as long as the Directors are of the opinion that the general financial conditions of the Company warrant such action." The letter stated that "on the basis of present operations," prospects for the continuance of the dividend through 1953 were exceptionally good, and that if the C.A.B. granted Air America's pending application, prospects for dividends would be substantially enhanced. Gearhart failed to disclose to the dealer the facts relating to the advances made to provide funds for the first two dividends.

31/ See Danser v. U.S., 281 F.2d 492, 496 (C.A. 1, 1960), which, in affirming the conviction of the president of a corporation for willfully employing a scheme to defraud in the offer and sale of that corporation's securities by the use of the mails, in violation of Section 17(a) of the Securities Act, held that the use of the mails by the underwriter, which the president should reasonably have foreseen, constituted sufficient evidence of the use of the mails by him.

Between July and September 1953, this dealer purchased a total of about 34,000 shares of Air America stock, including almost 18,000 from G & O, and sold approximately the same number to his customers. On the basis of the information furnished him by Gearhart, he caused a "Special Report" to be prepared which he distributed to prospective customers. This report presented a highly optimistic picture of the company's prospects, quoting extensively from Randall's dividend letter, and recommended the stock as an "outstanding speculative opportunity for income and substantial price appreciation." It contained no indication of the company's financial difficulties or the source of the first two dividend payments. The dealer testified that before mailing out the reports, he submitted copies to Gearhart who approved the contents. While Gearhart denied seeing the report, it is clear that he knew it was to be prepared and knew of its existence shortly after it was prepared.

Under these circumstances, G & O and Gearhart must be held accountable not only for the misleading information given in connection with G & O's own sales to the other dealer, but for the latter's dissemination of that information to his customers. 32/ The optimistic representations made by Gearhart personally and those in the Randall letter were obviously misleading in the light of Air America's financial difficulties subsequent to the date of that letter of which Gearhart was aware. The use of the letter at that stage was particularly fraudulent in light of the facts, which were also known to Gearhart, that Randall had come to the conclusion subsequent to the date of the letter that the company's financial position did not justify the payment of dividends, and that, at the April 30, 1953 directors' meeting, Randall and the other directors, except McCoy who abstained, voted against payment of a dividend, for that reason and because of the tax liens, and were informed by McCoy that the dividend had already been paid. The emphasis on the dividends conveyed the false impression that the company had funds available for their payment. Obviously, a disclosure that the company did not have funds of its own to pay even the small sums involved in the first two dividends, amounting to about $5,000 per dividend, and of the circumstances surrounding the first dividend payment, would have placed its financial position in an entirely different light.

Accordingly, we find that G & O, together with or aided and abetted by Gearhart, willfully violated the above-mentioned

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32/ See Van Alstyne, Noel & Company, 33 S.E.C. 311, 336-39 (1952).

anti-fraud provisions of the securities acts in the sale of Air America stock. 33/

(b) M & W and Willard

We also find, as did the hearing examiner, that Willard made false and misleading statements in the offer and sale of Air America stock. Among other things, he represented to customers at various times that C.A.B. approval of Air America's application for permission to operate coast-to-coast flights on a regular basis was imminent. These representations, which began only a week after the application was filed, did not have a reasonable basis. In addition, Willard recommended the stock to customers because it was selling at a reduced price, and made representations regarding the payment of a dividend, without disclosing Air America's adverse financial condition, or the fact that M & W and others had advanced the funds for such dividend.

Accordingly, we find that M & W, together with or aided and abetted by Willard, willfully violated the above anti-fraud provisions. 34/

II

NATIONAL LITHIUM CORPORATION

The order for proceedings alleges that Gearhart willfully violated Section 7 of the Securities Act, in causing

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33/ The mails were used in connection with the sales by G & O to the other dealer as well as that dealer's sales to its customers.

The hearing examiner also found Otis responsible for these violations, on the ground that because of his stock ownership and official position in G & O, he was in a position "to exercise decisive influence in the conduct of its operations in dealing with customers." However, Otis was not shown to have had any connection with or knowledge of these transactions, and under the circumstances we make no adverse findings with respect to him in this respect.

34/ The mails were used in connection with the offers and sales of Air America stock.

National Lithium to file a misleading and inadequate registration statement, 35/ and also alleges that the G & O respondents willfully violated the registration provisions of the Securities Act in connection with their transactions in National Lithium common stock.

Background

National Lithium was organized in November 1956 for the principal purpose of acquiring and developing certain mining claims containing lithium deposits in the Northwest Territories of Canada. The organization of the company and its acquisition of those claims were effected pursuant to a contract entered into in September 1956 between G & O, three Canadian corporations ("vendor corporations") from whom the claims were to be acquired, and Alexander J. Thomas, a Canadian prospector affiliated with those corporations. The contract, which was negotiated essentially by Gearhart and Thomas and signed on behalf of G & O by Otis, provided, among other things, that at the option of G & O, the claims would be assigned either to a new company to be organized or to Minerals, Inc., which had been organized a few months previously by Gearhart and others for the purpose of acquiring and developing certain mining properties, but which by this time was virtually defunct. The contract specified the cash and stock to be issued to the vendors for the claims, and provided for the issuance of shares to designees of G & O. It further provided for the designation by G & O and the vendor corporations of the directors of the new company or Minerals and for a public offering of 3,120,000 shares at $1.25 per share through G & O as underwriter.

Because of the existence or threat of certain claims against Minerals, it was decided to assign the mining claims to a new company rather than to Minerals. National Lithium was organized and Gearhart and the vendor corporations selected a board of 15 directors, including Gearhart. Pursuant to the contract, National Lithium on February 19, 1957 filed a registration statement with respect to the specified offering, which was signed, among others, by Gearhart as a director and as attorney-in-fact for two other directors. Thereafter we instituted stop order proceedings under Section 8(d) of the Securities Act.

35/ Section 7 of the Securities Act specifies the information which a registration statement filed under that Act must contain. It is implicit in the requirements of that Section that the information furnished be true and correct. Rosenson and Baumann, 40 S.E.C. 948, 952 (1961); Advanced Research Associates, Inc., Securities Exchange Act Release No. 7117, p. 32 (August 16, 1963).

G & O and Gearhart participated in those proceedings. On July 6, 1961, we entered an order suspending the effectiveness of the registration statement, based on findings that it contained materially misleading statements and omitted material facts required to be stated. 36/

Pursuant to a stipulation entered into by the G & O respondents and the Division, the record in the stop order proceedings was made a part of the instant record. 37/

Gearhart's Violation Relating to Registration Statement

The testimony adduced at the hearings in these proceedings with respect to Gearhart's alleged violation of Section 7 of the Securities Act was directed in large part to the extent to which Gearhart participated in the preparation of, or supplied information for, the National Lithium registration statement, and to the question whether and to what extent Gearhart

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36/ 40 S.E.C. 746 (1961).

37/ G & O respondents now urge that they entered into the stipulation on the basis of the Division's assurance that they would have an opportunity to cross-examine witnesses who had testified in the stop order proceedings, and that they withdrew from the stipulation when it appeared they would not be able to cross-examine certain of such witnesses who were beyond our territorial jurisdiction. They contend that under these circumstances, no reliance may be placed on the stop order record. While counsel for these respondents stated at one point during the hearings that he was withdrawing his stipulation unless the Division sent letters to certain Canadians who had testified in the stop order proceedings, urging them to make themselves available for examination by respondents, he expressed his satisfaction with letters to that effect thereafter written by the hearing examiner. The entire hearing on the National Lithium issues proceeded on the basis that the stop order record was part of the instant record. Under these circumstances, respondents cannot complain of a procedure to which they expressly agreed. We also note that G & O participated in the stop order hearings and had an opportunity to cross-examine the Canadian witnesses with respect to the issues involved in those hearings, while Gearhart as well as G & O participated in the post-hearing procedures in the stop order proceedings.

dominated its board of directors. It does not significantly add to or modify the testimony which was the basis of our findings in the stop order proceedings.

Respondents contend that Gearhart had no knowledge that the registration statement was misleading in any material respect or omitted required information, that he was not responsible for most of the information contained in it, and that he relied upon competent counsel, who had possession of all pertinent facts, for its preparation, and upon the reports of experts which were incorporated in it. However, Gearhart was primarily responsible for the terms of the contract leading to the creation of National Lithium and to the filing of the registration statement. He was more familiar than anyone else with the facts relating to the company's promotion and its preliminary financing. There can be little question that as a director, and within the areas of his special knowledge, he is accountable, under Section 7 of the Securities Act, for the misleading statements and omissions of material facts in the registration statement. But this does not mark the limit of his responsibility. As to those areas in which he did not have special knowledge, and where statements by an expert were not involved, Gearhart had a duty to make a reasonable investigation regarding the accuracy and adequacy of the information contained in the registration statement. 38/

The record establishes that Gearhart knew or reasonably should have known of certain material matters which were not disclosed or were not adequately disclosed in the registration statement. First, although the form of registration statement used by National Lithium specifically required disclosure of the

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38/ See Section 11(b)(3) of the Securities Act which imposes upon directors, among others, civil liability for untrue and misleading statements contained in a registration statement which are not based on the authority of any expert or public official document, if the director did not, after reasonable investigation, have reasonable ground to believe that the statements were true and not misleading.

In view of the fact that G & O, as the underwriter, was not cited in the order for proceedings with respect to the deficiencies in the National Lithium registration statement (see Charles E. Bailey & Company, 35 S.E.C. 33, 41 (1953); The Richmond Corporation, Securities Act Release No. 4584, pp. 7-9 (February 27, 1963)), Gearhart's responsibility, to the extent it is based on his position as a principal in the underwriter, is not before us.

principle followed in determining the valuation of property which had been acquired from a promoter, no disclosure was made of the basis on which the total consideration to be paid for the mining claims acquired by National Lithium was allocated between the vendor corporations. Gearhart testified that he considered this a package deal, had nothing to do with any allocation, and had "no interest in it."

In accordance with the terms of the underlying contract, National Lithium had issued a total of 4,880,000 shares to the vendor corporations, and the shares were placed in escrow for periods of either six or twelve months from the effective date of the registration statement. The registration statement represented that the vendor corporations were beneficial as well as record owners of 4,780,000 shares (one of the vendor corporations having resold 100,000 shares to a designee of G & O), and referred to their representations that the shares were being acquired for investment. It further stated that National Lithium considered the issuance and sale of these shares, as well as of the 2,000,000 shares issued to G & O's designees, to be exempt from registration under Section 4(1) of the Securities Act as transactions by an issuer not involving a public offering.

The record shows that in fact at least a part of the shares issued to the vendor corporations was beneficially owned by about 74 members of a group which had been instrumental in locating the claims and in organizing two of the vendor corporations. Those shares were to be distributed to such persons upon the release of the shares from escrow. Although the record does not show that Gearhart was familiar with these precise facts, his own testimony reflects his familiarity with the general nature of the arrangements contemplated. Thus, he testified that he understood the vendor corporations had split up some of the shares, and that "there is going to be some divisions, according to how the original investors invested it," but that he did not consider this to be his "concern." The record further shows that most of the approximately 74 members of the group were not promoters or insiders and they were not shown to have access to the type of information which registration would have supplied. Under these circumstances we think that Gearhart was at least on notice of facts indicating that the representations in the registration statement regarding the vendor corporations' beneficial ownership of the shares and investment intent and the claimed exemption from registration

were misleading. 39/ He should also have known that the claimed exemption was not available with respect to the 2,000,000 shares issued to G & O's designees, as is shown below in our discussion of the alleged violations by the G & O respondents of the registration provisions.

In addition, Gearhart must be held accountable for the misleading presentation in the registration statement regarding the company's business prospects. The record shows that National Lithium made an inadequate investigation of the various factors upon which the feasibility of the proposed venture was dependent, including mining, milling and transportation costs and the availability of markets for the product or products to be produced. Gearhart was or reasonably should have been aware of the cursory nature of such investigation and the extent of the problems which even on the basis of the facts then known made it highly unlikely that a profitable operation could be conducted in the foreseeable future.

Gearhart's reliance upon counsel to prepare the registration statement, and his furnishing information requested by counsel, did not relieve him of his obligation to furnish all material facts known to him or to check, by investigation if necessary, the accuracy and adequacy of the representations made. Accordingly, we conclude that Gearhart willfully violated Section 7 of the Securities Act.

Violations of Registration Provisions

Prior to the filing of its registration statement, National Lithium, through G & O, offered and sold 2,000,000 shares of its stock at 1¢ per share to about 26 persons designated by G & O. These purchasers were mostly persons who had invested in Minerals, including Gearhart and Otis, and the number of National Lithium shares offered to them was based on the extent of their respective investment in Minerals. Out of the block which he had purchased Gearhart sold shares to three or four additional persons. The approximately 30 purchasers consisted of officers and directors of and counsel for

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39/ Respondents urge that counsel who drafted the registration statement concluded independently that the vendor corporations were both record and beneficial owners of the shares issued to them and that their stockholders, qua stockholders, did not have a beneficial interest in those shares. However, the beneficial interest of the 74 persons arose not simply out of their status as stockholders of the vendor corporations, but out of the particular arrangements and agreements among those persons and between them and the vendor corporations.

National Lithium, officers and employees of G & O, and several business associates or friends of Gearhart. While a number of these persons were insiders, it has not been established by respondents that each of the others had access to the kind of information which registration would disclose and therefore the claimed private offering exemption was not available for the sale of the 2,000,000 shares. Moreover, such sales were in fact only part of an extensive distribution by National Lithium. As previously noted, the beneficial interest in at least part of the shares issued to the vendor corporations was acquired by a substantial number of persons who were stockholders of those corporations or had obtained mining claims for them, and Gearhart was or reasonably should have been aware of these facts.

Under these circumstances, since the G & O respondents were participants in a distribution of unregistered stock by National Lithium, we conclude that they willfully violated Sections 5(a) and 5(c) of the Securities Act. 40/

In December 1956, some two months before the registration statement was filed, G & O circulated to approximately 3,000 securities dealers two articles discussing the history and prospects of the metal lithium. They contained no reference to National Lithium or G & O. One article, in the form of a pamphlet entitled "Rocketing Lithium - the Missile and Market Sensation of 1957," 41/ referred to "the big upswing indicated in lithium" which "could be the market sensation of 1957," and stated that "a little vision" and "prudent selection of the right shares" could result in "spectacular gains." The pamphlet referred to the uses of lithium in industry and for atomic and hydrogen bombs and missile fuels, listed various areas where lithium had been found or where exploration was in progress, including the area where National Lithium's claims were located, and stated that the samples in the latter area were particularly rich and that the deposits there might exceed those in the other areas. It noted that there had already been a spectacular appreciation in the prices of certain other lithium stocks, and stated that the expected surge in 1957 related particularly to ore producers or prospectors. The second article, a reprint of a magazine article entitled "The Magic Metal Called Lithium," described in enthusiastic terms the "hundreds of uses" which

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40/ The mails were used by these respondents in connection with their offers and sales of National Lithium stock.

41/ This pamphlet was written by a close friend of Gearhart's, who had invested in Minerals and as a result had been "permitted" to purchase National Lithium shares.

had recently been discovered for lithium and spoke of its "important role in thermonuclear energy" and in "'high energy' fuels now being developed to propel intercontinental rockets."

Section 5(c) of the Securities Act makes unlawful the use of the mails or interstate facilities to offer to sell a security unless a registration statement has been filed as to such security. We find, as did the hearing examiner, that the distribution of the literature concerning lithium was the first step in a campaign to sell National Lithium stock and as such constituted an offer to sell such stock. Section 2(3) of the Securities Act defines "offer to sell" as including "every attempt or offer to dispose of, or solicitation of an offer to buy, a security. . ." This is a broad definition, not limited to communications which constitute an offer in the common law contract sense, or which on their face purport to offer a security, but includes any communication which is designed to procure orders for a security. 42/ While, as noted, the literature in question made no specific reference to National Lithium or to the prospective offering of its securities, it was designed to awaken an interest in lithium securities which could shortly afterwards be focused on the National Lithium stock. 43/ Moreover, Gearhart admitted that he sent out the literature "because I was going to do a lithium deal." We accordingly conclude that the G & O respondents willfully violated Section 5(c) of the Securities Act.

III

AMERICAN STATES OIL COMPANY

The order for proceedings alleges that G & O respondents willfully violated the registration provisions of Section 5 of the Securities Act in the sale and delivery of unregistered common stock of American States Oil Company ("American"). The record shows that between December 1954 and September 1955 G & O bought a total of more than 1,000,000 shares of American's stock from one J. Tom Grimmett, that it resold those shares to

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42/ See Carl M. Loeb, Rhoades & Co., 38 S.E.C., 843, 848 (1959); G. J. Mitchell, Jr., Co., 40 S.E.C. 409, 414 (1960).

43/ See Securities Act Release No. 3844 (October 8, 1957); cf. G. J. Mitchell, Jr., Co., supra. We also note that the literature was distributed after the contract, which led directly to the filing of the registration statement, was entered into.

other broker-dealers and to the investing public, and that no registration statement was filed with us with respect to any of American's securities.

The hearing examiner found that Grimmett controlled American, 44/ that G & O purchased the shares from him with a view to distribution 45/ and was therefore an "underwriter" within the meaning of Section 2(11) of the Securities Act with respect to the shares so purchased, and that its sales were in willful violation of the registration requirements.

G & O respondents contend that the history of these shares was such as to render their resale by G & O exempt from registration. That history, they assert, was as follows: (1) American issued them to Grimmett; (2) Grimmett transferred them to others; (3) Grimmett thereafter reacquired them from his transferees, who were neither underwriters nor in control of American and who were therefore free to sell to Grimmett or to anyone else without registration; and (4) Grimmett then sold them to G & O. 46/ They argue that since Grimmett's transferees

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44/ Grimmett formed American in May 1952 for the purpose of developing certain oil and gas properties in which he had interests. Grimmett became American's president, and caused American to issue 2,000,000 shares of its common stock to him in exchange for oil and gas interests. In the summer of 1952, American sold 575,000 shares to the public for 50 cents a share pursuant to Regulation A. By June 1954, Grimmett had transferred over 1,000,000 shares to others, but still owned at that time about 823,000 shares, the largest block owned by a single stockholder.

Toward the end of 1954 American issued an additional 3,200,000 shares of its stock (an amount considerably in excess of the aggregate number of shares that it had issued up to that time) to Grimmett, who took them in exchange for certain claims that he then had against American.

45/ Gearhart testified that as a rule G & O did very little business with the general public and did not normally employ any securities salesmen. However, at Grimmett's suggestion, G & O hired a salesman recommended by Grimmett to sell American stock to the public.

46/ This version of the shares' pedigree is, we think, unsupported by the record. For the purpose of discussing the legal conclusions that G & O respondents seek to draw therefrom we have however elected to treat their theory of the shares' history as though it were correct. One aspect

(Continued)

were free to resell their shares without registration, those shares were "free stock" that remained "free" even after Grimmett reacquired them and resold them to G & O, which in turn distributed them to investors. This notion that an exemption from registration attaches to, or "runs with," and becomes a permanent attribute of a security is completely fallacious. The exemptions from registration created by those sections of the Securities Act on which G & O respondents rely 47/ relate to particular offerings. Neither registration itself nor the sort of an exemption therefrom alleged to have been present here attaches to the security. A subsequent offering of securities that have once been registered or once been sold pursuant to some valid exemption from the statutory registration requirements must stand on its own feet. The sale to the public by a controlling person of a large block of securities previously exempted from registration entails all of the dangers incident to a new offering of securities to the public. 48/

Accordingly, we conclude that G & O respondents violated Sections 5(a)(1) and 5(a)(2) of the Securities Act by selling and delivering the American shares that G & O had acquired from Grimmett at a time when he controlled American.

G & O respondents contend that these violations were not willful. They assert that they did not know that Grimmett controlled American, and they also claim to have believed that the American shares that G & O was buying were really being sold to it by persons other than Grimmett. The record does not support either position.

G & O respondents were on notice that Grimmett might be in control of American. Grimmett had negotiated with G & O in seeking the amalgamation of American with another company which supposedly had funds that American could have used to pay off its creditors. His active role in that connection should have suggested to one with Gearhart's experience that an inquiry into

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46 contd./

of the history is undisputed however, namely, that G & O acquired the stock from Grimmett.

47/ Sections 3(b) and 4(1).

48/ See S.E.C. v. A. G. Bellin Securities Corp., 171 F. Supp. 233 (S.D.N.Y., 1959); Thompson Ross Securities Co., 6 S.E.C. 1111, 1117-18 (1940).

Grimmett's relationship to American was essential. Grimmett's offer to sell to G & O a substantial block of stock in so obscure a company as American was an even more significant factor in alerting G & O respondents to the need for inquiring as to his status in American. 49/

G & O respondents' claim of ignorance with respect to the true source of the more than 1,000,000 American shares that G & O obtained from Grimmett and distributed is predicated on the assertion that they believed that such shares were owned by 10 customers in whose names Grimmett had opened accounts with G & O. None of these "customers," all but one of whom resided in Oklahoma, ever appeared at G & O's offices in New York City or filled out a customer's signature card. The orders to sell always came to G & O directly from Grimmett. Grimmett always saw to it that the certificates necessary to cover the sales were delivered to G & O, and many of G & O's checks drawn in payment for the stock bore Grimmett's name as the final endorser. Nothing in the record tends to suggest that G & O respondents ever attempted to check on the relationship of the "customers" to Grimmett or on the sources from which those "customers" had obtained the shares that they were selling to G & O in substantial blocks.

G & O respondents also claim to have acted in reliance on legal advice rendered to G & O by a law firm that had acted for Grimmett and for American. They contend that this alleged reliance shows that their violations were not willful. As we have already pointed out, a violation is "willful" whenever the actor intends to do the act that constitutes the violation without regard to whether he specifically intends to violate the law. Hence reliance on the advice of counsel does not negate willfulness. 50/

49/ See Distribution by Broker-Dealers of Unregistered Securities, Securities Act Release No. 4445, Securities Exchange Act Release No. 6721, p. 2 (February 2, 1962). Cf. S.E.C. v. Mono-Kearsarge Consolidated Mining Company, 167 F. Supp. 248, 259 (D. Utah, 1958); Sutro Bros. & Co., Securities Exchange Act Release No. 7053, p. 10 (April 10, 1963).

50/ The only written opinion of counsel here in evidence dealt with the status of Grimmett's transferees and did not go to the propriety of what G & O was actually doing, i.e. buying shares from Grimmett and reselling them to the public. In fact, it clearly pointed out that Grimmett controlled American.

IV

PUBLIC INTEREST AND OTHER MATTERS

In view of respondents' willful violations, we must determine whether it is in the public interest to revoke the broker-dealer registrations of G & O and M & W, or suspend or expel G & O from membership in the NASD, and whether the individual respondents are each a cause of any such action against their respective firms. As we have found, respondents unlawfully sold securities of Air America without registration, and made fraudulent representations in the offer and sale of such securities. In addition, the G & O respondents unlawfully sold unregistered stock of National Lithium and American, and Gearhart caused the former company to file a registration statement containing misleading and inadequate information.

With respect to the G & O respondents, we cannot accept their argument that their violations of the registration and anti-fraud provisions were merely technical in nature. 51/

McCoy's asserted effort to save and develop Air America for the benefit of its stockholders, and his and Willard's claimed belief that it had a bright future, could not justify their deviation from basic requirements of the securities acts enacted for the protection of investors. Indeed, Willard's deliberate expansion of the offering of Air America stock in 1953 to well beyond the number of persons upon which counsel's advice was based reflected a callous disregard for those requirements. We have already discussed McCoy's awareness of the problems relating to the collection of Air America's accounts receivable, which should have been reflected in the offering circular which he signed. Moreover, he was by his own admission "very careless" in determining its accuracy. Such conduct, which is as inimical to the interests of investors as intentional misstatements, cannot be ascribed entirely to the fact that he had had only limited experience in the securities field.

Finally, the other factors urged in mitigation - including the punishment already suffered by respondents in terms of time and money expended and adverse publicity, the lapse of time since M & W ceased doing business, the fact that McCoy has

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51/ There is obviously no merit in the contention advanced by those respondents that the significance of the evidence against them was improperly magnified by its cumulative effect resulting from the "consolidation" of three separate proceedings. Only one proceeding, relating to three different securities, was instituted.

not been in the securities business since 1955 and does not contemplate re-entering that business, and the fact that Willard had been in business 16 years without any charges having been made against him by this Commission - are not in our opinion sufficient to overcome the serious nature and extent of the violations found.

Accordingly, we conclude as did the hearing examiner that it is necessary and appropriate in the public interest to revoke the broker-dealer registrations of G & O and M & W and to expel G & O from its membership in the NASD. 52/ We further conclude that Gearhart and Otis are each a cause of the revocation of G & O's registration and of G & O's expulsion from NASD membership, and that McCoy and Willard are each a cause of the revocation of M & W's registration.

We deny the renewed motion by the M & W respondents to dismiss the proceedings with respect to them. They again contend that we lacked jurisdiction to institute the proceedings against them because M & W had been dissolved, and we affirm our previous ruling rejecting that contention. 53/ In addition, they urge that Section 15(b) of the Exchange Act and Section 9(b) of the Administrative Procedure Act contemplate action only against registrants actually in existence. This contention is also without merit. Registration continues until terminated either by revocation, withdrawal or cancellation under Section 15(b). Section 9(b) requires that licensees be accorded an opportunity to comply with applicable requirements before revocation proceedings are instituted. However, these proceedings are clearly within the exceptions expressly provided in that section for cases of willfulness or those in which the public interest requires otherwise. 54/ We also reject respondents' renewed contention that the order for proceedings did not properly apprise them of the issues raised. There is no

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52/ In 1955, we issued an order suspending G & O from NASD membership for 10 days, and finding Gearhart a cause of such suspension, on the basis of findings that respondents, in willful violation of Section 5(a)(1) of the Securities Act, sold securities prior to the effective date of a registration statement covering them. 36 S.E.C. 327.

53/ See W. T. Anderson Company, Inc., 39 S.E.C. 630, 632-33 (1960). Cf. Peoples Securities Company v. S.E.C., 289 F.2d 268 (C.A. 5, 1961).

54/ See Sterling Securities Company, 37 S.E.C. 837 (1957).

substance to the other arguments made in support of the motion. We find that movants received a fair hearing. Accordingly the motion to dismiss is denied. 55/

An appropriate order will issue.

Chairman CARY and Commissioner OWENS join in the above opinion, Commissioners WOODSIDE and COHEN not participating.

Orval L. DuBois
Secretary

55/ We have considered the recommended decision of the hearing examiner and the exceptions thereto, and to the extent such exceptions involve issues which are relevant and material to the decision in this case, we have by our Findings and Opinion herein already ruled upon them. We expressly sustain such exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule them to the extent that they are inconsistent with such views.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
June 2, 1964

In the Matter of GEARHART & OTIS, INC. File No. 8-2729 Securities Exchange Act of 1934 - Sections 15(b) and 15A	ORDER REVOKING BROKER-DEALER REGISTRATIONS AND EXPELLING FROM REGISTERED SECURITIES ASSOCIATION
In the Matter of McCOY & WILLARD File No. 8-3389 Securities Exchange Act of 1934 - Sections 15(b) and 15A	

Proceedings having been instituted pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 to determine whether to revoke the registrations as brokers and dealers of Gearhart & Otis, Inc. and McCoy & Willard, whether to suspend or expel Gearhart & Otis, Inc. from membership in the National Association of Securities Dealers, Inc., a registered securities association, and whether Frederick D. Gearhart, Jr., Edward V. Otis, William D. McCoy, and Alvin Willard are each a cause of any sanction that may be imposed upon the registrant with which they were associated;

Hearings having been held after appropriate notice, the hearing examiner having submitted a recommended decision, exceptions thereto having been filed by respondents, a reply having been filed by the Division of Trading and Markets of the Commission, and oral argument having been presented to the Commission;

The Commission having this day issued its Findings and Opinion; on the basis of said Findings and Opinion

IT IS ORDERED that the registrations as brokers and dealers of Gearhart & Otis, Inc. and McCoy & Willard be, and they hereby are, revoked, and that Gearhart & Otis, Inc. be, and it hereby is, expelled from membership in the National Association of Securities Dealers, Inc., and it is found that Frederick D. Gearhart, Jr. and Edward V. Otis are each a cause of this order with respect to Gearhart & Otis, Inc., and that William D. McCoy and Alvin Willard are each a cause of this order with respect to McCoy & Willard.

By the Commission.

Orval L. DuBois
Secretary

BEFORE THE

SECURITIES AND EXCHANGE COMMISSION [1]

In the Matter of:

GEARHART & OTIS, INC. File No. 8-2729

McCOY & WILLARD File No. 8-3389

Room 292, Securities and Exchange Commission Building

425 Second Street, N.W.

Washington, D. C.

Thursday, March 1, 1962

The above-entitled matter came on for oral argument, pursuant to notice, at 3:00 o'clock p.m.

BEFORE:

WILLIAM L. CARY, Chairman
MANUEL F. COHEN, Commissioner
JACK M. WHITNEY, Commissioner

APPEARANCES:

ESTHER ANTELL, Division of Trading and Exchanges, New York Regional Office, on behalf of the Securities and Exchange Commission.

ALAN R. GORDON, Division of Corporate Finance, on behalf of the Securities and Exchange Commission.

JOSEPH W. KIERNAN, 815 Fifteenth Street, N.W., Washington 5, D. C., on behalf of McCoy & Willard.

ARCHIBALD PALMER on behalf of Gearhart & Otis.

P R O C E E D I N G S [2]

CHAIRMAN CARY: This is an oral argument in consolidated proceedings, pursuant to Sections 15(b) and 15A of the Securities Exchange Act of 1934 to determine whether it is in the public interest to revoke the registrations as brokers and dealers of Gearhart & Otis, Inc. and McCoy and Willard, whether Gearhart & Otis, Inc. should be suspended or expelled from membership in the National Association of Securities Dealers, Inc., and whether Frederick D. Gearhart, Jr., Edward V. Otis, William D. McCoy, and Alvin Willard are each a cause of any order of revocation, suspension or expulsion which may be entered.

The hearing examiner submitted a recommended decision, exceptions and supporting briefs were filed by the respondents, and the Division of Trading and Exchanges filed a reply.

I might say that Commissioner Woodside has disqualified himself from this case and therefore there would be four Commissioners deciding it.

It is proposed that any Commissioner at the time a decision is rendered in this case who has not disqualified himself may participate therein, with the understanding that if he was not present at this oral argument he will read the transcript of the argument.

Is this agreeable to all counsel?

MR. KIERNAN: It is agreeable to McCoy and Willard.

MISS ANTELL: Yes.

MR. PALMER: I beg your Honor's pardon. Ordinarily, would that mean there would be four Commissioners sitting?

CHAIRMAN CARY: That would mean in this particular case that, assuming that all of us are still living, it would be decided by four Commissioners apart from Commissioner Woodside, who has disqualified himself.

MR. PALMER: You will forgive me because this is the second time in my life, and it has been a long life, that I have appeared before the Commissioners, I have seen them as individuals. Would that mean, then, that Commissioner Woodside would then read this record before making the decision?

CHAIRMAN CARY: It does not mean that. He has disqualified himself from deciding this case or participating in it.

MR. PALMER: And the other Commissioner - -

CHAIRMAN CARY: Commissioner Frear, having read the record, will participate in the decision.

MR. PALMER: Having read the record?

CHAIRMAN CARY: Having read the record.

MR. PALMER: Your Honor understands only part of the record is in the room.

CHAIRMAN CARY: I will not say he will have read every page of it, but I merely mean that he will have satisfied

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himself, put it that way.

MR. PALMER: Will you forgine (sic) me, then, for asking these questions?

CHAIRMAN CARY: Proceed.

MR. PALMER: I have nothing to proceed, you have told me.

CHAIRMAN CARY: What is your conclusion?

MR. PALMER: My conclusion is to do what you have asked before. I am satisfied to have the absent Commissioner read the record and see the exhibits and then join in with the others.

CHAIRMAN CARY: I will not guarantee for him that he will read every page in that record. Perhaps I should now repeat my previous statement. It is proposed that any Commissioner at the time a decision is rendered in this case who has not disqualified himself may participate therein, with the understanding that if he was not present at this oral argument he will read the transcript of the argument. I do not say that he will read all of the record.

MR. PALMER: The transcript of the argument?

CHAIRMAN CARY: Yes.

MR. PALMER: Heaven help you gentlemen if you had to read the transcript of the record; the argument might be bad enough.

CHAIRMAN CARY: I agree with you. I will not speak

[5]

for the argument; obviously, that remains to be seen.

MR. PALMER: When I find the Commission agrees with me, I had best sit down.

CHAIRMAN CARY: Upon your sitting down, may we assume that the Commissioner who is not present may participate in the case?

MR. PALMER: Yes, your Honor.

CHAIRMAN CARY: That is all we want to know.

* * * *

BRIEF FOR PETITIONERS

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18,817

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR. AND EDWARD V. OTIS,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION AND UNITED STATES OF AMERICA,

Respondents,

Petition for Review of An Order of Securities and Exchange Commission

CHARLES S. RHYNE
COURTS OULAHAN
EDWARD D. COXEN, JR.
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Washington 7, D. C.

Attorneys for Petitioners

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Attorneys for Petitioners

STATEMENT OF QUESTIONS PRESENTED

1. Whether the Securities and Exchange Commission failed to conclude an administrative hearing with reasonable dispatch, as required by Section 6(a) of the Administrative Procedure Act, 5 U.S.C. §1005(a), where, in a consolidated proceeding involving some alleged acts committed more than ten years before the issuance of its decision, the period of time from the commencement of the proceeding until such decision was approximately 94 months, as compared with an average of 28.6 months for similar proceedings before the agency, including a period of 35 months (as compared with an average of 13.5 months for similar Commission proceedings) from the date of the Hearing Examiner's recommended decision to that of the Commission's order, during at least six months of which period the agency, by failing to decide the case prior thereto, was without a quorum to make such a decision.

2. Whether, after the Registrant and individual petitioners at oral argument before the agency only agreed to the participation therein by an absent but then serving commissioner, the Commission lawfully could render a decision by only two of the Commissioners who heardoral argument, less than a majority of a quorum, and by a third Commissioner who had joined the agency after oral argument, the Commission, by its inaction for nineteen months, having rendered itself unable to decide the proceeding by a quorum of the members thereof at the time of oral argument.

3. Whether the Commission satisfies the legal standard required for a willful violation of the securities statutes, in conjunction with ancillary findings that the Registrant willfully violated the statutes and the principals of such Registrant aided and abetted such violation, by merely holding that such principals knew what they were doing, without having an intention to violate the law.

4. Whether the Commission, in a broker-dealer proceeding which involved securities theretofore the subject of a stop-order proceeding and an agency decision, had the jurisdiction to find a principal of the broker-dealer, as a director of the issuer and not as such principal, in willful violation of Section 7 of the Securities Act of 1933, 15 U.S.C. §77g.

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TABLE OF CASES AND OTHER AUTHORITIES

UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18, 817

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR., and EDWARD V. OTIS,

Petitioners

v.

SECURITIES AND EXCHANGE COMMISSION and UNITED STATES OF AMERICA,

Respondents.

PETITION FOR REVIEW OF AN ORDER OF THE SECURITIES AND EXCHANGE COMMISSION

PETITIONERS' BRIEF

JURISDICTIONAL STATEMENT

This petition involves orders for proceedings issued by the Securities and Exchange Commission under the Securities Act of 1933 and the Securities Exchange Act of 1934 (Cert. Tr. 23909, 23919, 24007) which resulted in Findings, Opinion, and Order issued by the agency June 2, 1964 (Cert. Tr. 25123). The jurisdiction of this Court to review the Findings, Opinion, and Order of the Commission and to modify or set aside, in whole or in part, said Findings, Opinion, and Order is based upon Section 9 of the Securities Act of 1933,

15 U.S.C. §77i, Section 25 of the Securities and Exchange Act of 1934, 15 U.S.C. §78y, and Section 10 of the Administrative Procedure Act, 5 U.S.C. §1009.

STATEMENT OF THE CASE

After an investigation commencing in June, 1954 (Cert. Tr. 17457, 17549, 17631), the Commission's proceedings herein were commenced by two separate orders of the Commission issued August 30, 1957, which also consolidated the proceedings for purposes of hearing and decision (Cert. Tr. 23909, 23919) as amended by Amending Order dated January 8, 1958 (Cert. Tr. 24007). The Commission's proceedings specifically involved the following:

a. Whether it was in the public interest to revoke the registration as broker and dealer of Gearhart & Otis, Inc. (Registrant and a petitioner herein) pursuant to Section 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78o(b).

b. Whether it was necessary or appropriate in the public interest or for the protection of investors to suspend Registrant for a period not exceeding twelve months or to expel it from membership in the National Association of Securities Dealers, Inc., pursuant to Section 15A (1)(2) of the Securities Exchange Act of 1934, 15 U.S.C. §78o - 3(1)(2).

c. Whether the Commission should find that Respondents Gearhart and Otis (individual petitioners herein), or any of them, were the cause of

any such order of revocation, suspension, or expulsion, within the meaning of Section 15A(b) of the Securities Exchange Act, 15 U.S.C. §78o-3(b)(4).

Transactions in, and activities with respect to, three separate corporations and the securities thereof were alleged by the Commission to be the subject of the proceedings:

a. Air America, Inc., including certain alleged transactions in 1953 through 1957 in certain securities thereof.

b. National Lithium, Inc., including the filing of an allegedly misleading and inadequate registration statement on February 19, 1957, with respect to which the Commission had issued a stop-order, 40 S.E.C. 746 (1961), and the alleged sale of the securities thereof in late 1956 prior to the effective date of said registration statement, all in alleged violation of the Securities Act of 1933.

c. American States Oil Company, including the alleged sale and delivery of unregistered shares thereof in 1954 through 1956 in violation of the Securities Act of 1933.

After extensive hearings commencing November 18, 1957, and ending January 7, 1959 (Cert. Tr. 1-16, 116), the Hearing Examiner issued his recommended decision on July 26, 1961 (Cert. Tr. 24, 546). The case was submitted to the Commission on exceptions and briefs, and after oral argument, on March 1, 1962. Commissioners Cary, Cohen, and Whitney heard the oral argument. Commissioner Frear was absent, and Commissioner Woodside disqualified himself (Cert. Tr., Doc. 1099, Oral Arg. 1-4).

On September 30, 1963, Commissioner Frear left the service of the Commission. On March 23, 1964, Commissioner Owens commenced his service on the Commission. On June 2, 1964, the Commission issued its Findings, Opinion, and Order, Commissioners Cary, Whitney, and Owens signing the decision and Commissioners Cohen and Woodside not participating (Cert. Tr. 25123). This decision constituted the initial, and final, agency decision in the case. The decision ordered the registration of Registrant as broker and dealer revoked and the firm expelled from the National Association of Securities Dealers, Inc. The individual Respondents each were held a cause of the order for revocation and expulsion.

The petition herein seeks review of the Commission's order without having requested a stay thereof. The Registrant has been out of business since early 1964.

STATUTES INVOLVED

Administrative Procedure Act.

Section 2 (5 U.S.C. §1001), Definitions.

"As used in this Act -

***

> "(f) Sanction and Relief. - 'Sanction' includes the whole or part of any agency (1) prohibition, requirement, limitation, or other condition affecting the freedom of any person; (2) withholding of relief; (3) imposition of any form of penalty or fine; (4) destruction, taking, seizure, or withholding of property; (5) assessment of damages, reimbursement, restitution, compensation, costs, charges, or fees; (6) requirement, revocation,

or suspension of a license; or (7) taking of other compulsory or restrictive action.***"

Section 6 (5 U.S.C. §1005), Ancillary Matters.

"Except as otherwise provided in this Act -

"(a) Appearance. - *** Every agency shall proceed with reasonable dispatch to conclude any matter presented to it except that due regard shall be had for the convenience and necessity of the parties or their representatives. ***"

Section 8 (5 U.S.C. §1007), Decisions.

"In cases in which a hearing is required to be conducted in conformity with section 7 -

"(b) Submittals and Decisions. - *** All decisions (including initial, recommended, or tentative decisions) shall become a part of the record and include a statement of (1) findings and conclusions, as well as the reasons or basis therefor, upon all the material issues of fact, law, or discretion presented on the record; and (2) the appropriate rule, order, sanction, relief, or denial thereof."

Section 9 (5 U.S.C. §1008), Sanctions and Powers.

"In the exercise of any power or authority -

"(a) In General. - No sanction shall be imposed or substantive rule or order be issued except within jurisdiction delegated to the agency and as authorized by law."

Section 10 (5 U.S.C. §1009), Judicial Review.

"Except so far as (1) statutes preclude judicial review or (2) agency action is by law committed to agency discretion -

"(a) Right of Review. - Any person suffering legal wrong because of any agency action, or adversely affected or aggrieved by such action within the meaning of any relevant statute, shall be entitled to judicial review thereof.

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"(c) Reviewable Acts. - Every agency action made reviewable by statute and every final agency action for which there is no other adequate remedy in any court shall be subject to judicial review. Any preliminary,

procedural, or intermediate agency action or ruling not directly reviewable shall be subject to review upon the review of the final agency action. Except as otherwise expressly required by statute, agency action otherwise final shall be final for the purposes of this subsection whether or not there has been presented or determined any application for a declaratory order, for any form of reconsideration, or (unless the agency otherwise requires by rule and provides that the action meanwhile shall be inoperative) for an appeal to superior agency authority.

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"(e) Scope of Review. - So far as necessary to decision and where presented the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of any agency action. It shall (A) compel agency action unlawfully withheld or unreasonably delayed; and (B) hold unlawful and set aside agency action, findings, and conclusions found to be (1) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; (2) contrary to constitutional right, power, privilege, or immunity; (3) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; (4) without observance of procedure required by law; (5) unsupported by substantial evidence in any case subject to the requirements of sections 7 and 8 or otherwise reviewed on the record of an agency hearing provided by statute; or (6) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court. In making the foregoing determinations the court shall review the whole record or such portions thereof as may be cited by any party, and due account shall be taken of the rule of prejudicial error."

Securities Act of 1933

Section 7 (15 U.S.C. §77g), Information Required In Registration Statement.

"The registration statement ... shall contain the information, and be accompanied by the documents, specified in Schedule A. .... If any accountant, engineer, or appraiser, or any person whose profession gives authority

to a statement made by him, is named as having prepared or certified any part of the registration statement, or is named as having prepared or certified a report or valuation for use in connection with the registration statement, the written consent of such person shall be filed with the registration statement. If any such person is named as having prepared or certified a report or valuation (other than a public official document or statement) which is used in connection with the registration statement, but is not named as having prepared or certified such report or valuation for use in connection with the registration statement, the written consent of such person shall be filed with the registration statement unless the Commission dispenses with such filing as impracticable or as involving undue hardship on the person filing the registration statement. Any such registration statement shall contain such other information, and be accompanied by such other documents, as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors."

Section 9 (15 U. S. C. §77i), Court Review Of Orders.

"Any person aggrieved by an order of the Commission may obtain a review of such order ... in the Court of Appeals of the District of Columbia, by filing in such Court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or be set aside in whole or in part. *** No objection to the order of the Commission shall be considered by the courts unless such objection shall have been urged before the Commission. The finding of the Commission as to the facts, if supported by evidence, shall be conclusive. If either party shall apply to the Court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the hearing before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. * * *"

Securities Exchange Act of 1934

Section 15 (U.S.C. §78o), Over-the-Counter Markets; registration of brokers; information and reports.

> "(a) No broker or dealer ... shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security ... otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section.
>
> "(b) A broker or dealer may be registered for the purposes of this section by filing with the Commission an application for registration....
>
> * * *
>
> "The Commission shall, after appropriate notice and opportunity for hearing, by order deny registration to or revoke the registration of any broker or dealer if it finds that such denial or revocation is in the public interest and that (1) such broker or dealer whether prior or subsequent to becoming such, or (2) any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, whether prior or subsequent to becoming such .... (D) has willfully violated any provision of the Securities Act of 1933, or of this chapter, or of any rule or regulation thereunder. ***"

Section 15A (15 U.S.C. §780-3), Over-the-Counter brokers' or dealers' associations; registration - Association registration; national and affiliated; data.

***

> "(b) An applicant association shall not be registered as a national securities association unless it appears to the Commission that -
>
> * * *

"(4) the rules of the association provide that, except with the approval or at the direction of the Commission in cases in which the Commission finds it appropriate in the public interest so to approve or direct, no broker or dealer shall be admitted to or continued in membership in such association, if (1) such broker or dealer, whether prior or subsequent to becoming such, or (2) any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), or any person directly or indirectly controlling or controlled by such broker or dealer, whether prior or subsequent to becoming such ... (B) is subject to an order of the Commission denying or revoking his registration pursuant to section 78o of this title, or expelling or suspending him from membership in a registered securities association (whether national or affiliated) or from a national securities exchange, or (C) by his conduct while employed by, acting for, or directly or indirectly controlling or controlled by, a broker or dealer, was a cause of any suspension, expulsion, or order of the character described in clause (A) or (B) which is in effect with respect to such broker or dealer;"

Section 25 (5 U.S.C. §78y), Court review of orders.

"(a) Any person aggrieved by an order issued by the Commission in a proceeding under this title to which such person is a party may obtain a review of such order ... in the Court of Appeals of the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. *** Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record shall be exclusive, to affirm, modify, and enforce or set aside such order, in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission. The finding

of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If either party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the hearing before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts, by reason of the additional evidence so taken, and it shall file such modified or new findings, which, if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. ***"

STATEMENT OF POINTS

1. The Commission did not act with reasonable dispatch, and therefore violated the requirements of Section 6(a) of the Administrative Procedure Act, 5 U.S.C. §1005(a), thereby subjecting Registrant and the individual petitioners to an unauthorized sanction prohibited by Section 9(b) thereof, 5 U.S.C. §1008(b), in that

a. The consolidated proceedings involved an investigation commencing, and events occurring, more than ten years before the issuance of the Commission's final decision herein.

b. The period of time from the start of the hearings to the date of the Commission's decision involved approximately 94 months, as compared with an average of 28.6 months for similar proceedings before the Commission.

c. The period of time from the opening of the hearings to the date when the administrative record was closed involved 26 months, as compared with an average of 7.1 months for similar proceedings before the Commission.

d. The period of time from the date when the record was closed to the issuance of the Hearing Examiner's recommended decision involved 30 months, as compared with an average of 3.3 months for similar Commission proceedings.

e. The period of time from the date when the recommended decision was issued to the date of the final decision by the Commission involved 35 months, as compared with an average of 13.5 months for similar Commission proceedings.

2. The Commission's final decision was void as a matter of law as the result of the agency's own action whereby only two of the four members thereof who heard the oral argument, or less than the quorum required for a decision, participated in the decision and the deciding vote was cast by a third Commissioner who was not a member when oral argument was heard, and who joined the agency two years after such argument. Registrant and the individual respondents did not waive, at the request of the agency chairman at oral argument, their right to a decision by the Commission as then constituted at the time of such argument.

3. The standard of willfulness employed by the Commission has no legal basis and does not provide an ascertainable one whereby a registrant

and individual respondents, in the proceeding below or in any other similar proceeding, can act with knowledge of the consequences thereof. Use of this standard was rendered further void by the Commission's holding that the alleged willful violations by individual respondents would be attributed to Registrant; that, as a result of their alleged willful violation, the individual respondents aided and abetted the willful violation by Registrant; and that, as a result of the foregoing, individual respondents were causes of the revocation of Registrant's registration.

4. The Commission erroneously found that Respondent Gearhart, solely as a director of National Lithium, Inc., and not as a principal of Registrant, willfully violated Section 7 of the Securities Act of 1933, 5 U. S. C. §77g. Section 7 merely deals with "Information Required In Registration Statements" and establishes no legislative or implied sanction for a claimed violation thereof. Even if, as alleged by the Commission, Gearhart must be held accountable for the misleading presentation in the registration statement regarding an issuer's business prospects, said accountability is to the issuer only and not to the Commission in a broker-dealer proceeding.

5. The cumulative effect of the foregoing errors of law, each in itself of sufficient importance to warrant a reversal of the decision below, was to deny petitioners due process of law and equal protection of the laws. To reverse the Commission would not be an act of judicial nullity but one to restore to Commission proceedings, in the important areas involved in this appeal, the rule of law and to implement the letter and spirit of the Administrative Procedure Act.

SUMMARY OF ARGUMENT

The Commission is required under Section 6(a) of the Administrative Procedure Act to proceed with reasonable dispatch to conclude any matter before it. Congress did not intend a mere exhortation to administrative discretion and expertise. The requirement was, and is, a fundamental article of the administrative bill of rights incorporated in that statute. Failure of an administrative agency to obey this injunction constitutes a per se violation of the statute and a denial of due process and of equal protection of the laws. Such failure occurred in this proceeding, to the substantial prejudice of petitioners. Reasonable dispatch does not occur, as a matter of law, where a proceeding initiated by investigation in 1954 and involving some matters occurring in 1953 took nearly eight years to adjudicate (1957-1964). This period included more than two years after the date the case was submitted to the agency, during which time for six months the agency could not reach a decision because, due to its prior inaction, it was without a lawful quorum to decide.

At oral argument before the Commission, the then counsel for petitioners refused to waive the right of his clients to a decision by the members then constituting the agency, including one absent but then serving. This occurred on March 1, 1962. In September, 1963, approximately eighteen months later, this member left the Commission, but the agency to that date had taken no action. For six months the agency was without a quorum to decide the case. A new member joined the Commission in March, 1964. Thereupon, within a few months, a decision was finally issued. Without the vote of the

new member, the agency could not have acted. Where as here, the vote of the new agency member, who did not hear oral argument and whose participation in the decision was not waived, is decisive in effecting the entry of the administrative order, the agency acted contrary to law. Under these circumstances, the order of the Commission should be held void and of no effect.

In their implementation of the federal securities statutes, the Commission has fashioned a novel concept of willfulness. This concept is that one can act willfully without intending the consequences of one's action or, stated in the terms of a recent Commission decision, willfully but unintentionally. Having in effect made such a finding below with respect to the individual petitioners, the Commission then went on to impute this willfulness to the Registrant, to hold that the individual petitioners aided and abetted the Registrant in such a violation of law, and to hold that the individual petitioners were a cause for revocation within the meaning of the statute, thus precluding them from any further employment with a registered broker-dealer without prior Commission approval. If Congress had intended the term "willful" to be meaningless, as indeed the Commission has interpreted it, then the legislature would have left willful out of the statute. This Congress did not do. The application of the Commission's meaningless standard to the individual petitioners - as well as the subsequent use of this standard to hold, without any explanation thereof and therefore in violation of Section 8(b) of the Administrative Procedure Act, 5 U.S.C. §1007(b), that individual petitioners aided and abetted the Registrant in a willful violation and thus were a cause for revocation - constituted a viola-

tion of due process of law and a denial of the equal protection of the laws.

The Commission further erred in finding that one of the individual petitioners violated the requirements of Section 7 of the Securities Act of 1933, 5 U.S.C. §77g, as a director of an issuer and not as a principal of a broker-dealer. Indeed, the Commission frankly recognized it had no jurisdiction to make such a finding against the petitioner in his principal capacity. However, the Commission only had jurisdiction over the petitioner in this proceeding as a principal, and its finding was without authority. Further, the Commission fashioned for itself in this decision below a novel form of violation of the securities statutes, without basis in Section 7 or in other provision of applicable law.

The foregoing errors of law were serious. Even if the individual petitioners had not suffered business and economic consequences, being finally forced out of business, and thus had a sanction imposed upon them, the errors were such as to require this Court to reverse the Commission's decision. Their cumulative effect, considered in the context of the Congressional intent in enacting the Administrative Procedure Act, can only lead to such a result.

ARGUMENT

I. THE COMMISSION FAILED TO ACT WITH REASONABLE DISPATCH IN COMPLIANCE WITH SECTION 6(a) OF THE ADMINISTRATIVE PROCEDURE ACT.

The Administrative Procedure Act was enacted in 1947 as a fundamental bill of rights to govern agency proceedings. The agencies were required to "make the first, primary and most far-reaching effort to comply with the terms and the spirit" of the Statute, S. Doc. No. 248, 79th Cong., 2d Sess. 217 (1947). The statute was to be construed "to eliminate, so far as its text permits, the practices it condemns", Wong Yang Sung v. McGrath, 339 U.S., 33, 45.

This proceeding affords the Court an opportunity, and indeed justifies a decision, to implement the provisions of Section 6(a) of the statute, 5 U.S.C. §1005(a).

A. The statute requires the agency to act with reasonable dispatch.

Section 6(a) of the Administrative Procedure Act provides:

> "***Every agency shall proceed with reasonable dispatch to conclude any matter presented to it except that due regard shall be had for the convenience and necessity of the parties or their representatives.***"

This provision "requires agencies to proceed with reasonable dispatch", S. Doc. No. 248, supra at 363. Congress made clear its intention in enacting

Section 6(a), as follows, ibid. at 264:

> "The requirement that agencies proceed 'with reasonable dispatch to conclude any matter presented' means that no agency shall in effect deny relief or fail to conclude a case by mere inaction, or proceed in dilatory fashion to the injury of the persons concerned. No agency should permit any person to suffer injurious consequences of unwarranted official delay."

Section 10(e)(A) and (B)(4) of the same act empowers a reviewing court to "compel agency action unlawfully withheld or unreasonably delayed" and to "hold unlawful and set aside agency action ... without observance of procedure required by law", 5 U.S.C. §1009(e)(A) and (B)(4).

Implementation of Section 6(a), in letter as well as spirit - or, rather, the lack of it - has been a matter of serious concern to the bench, bar, regulated industry, and public. "There can be little doubt that the protracted delays accompanying agency adjudications constitute a serious and notorious shortcoming in administrative procedure", Montgomery, Discovery in Federal Administrative Proceedings, 16 Stan. L. Rev. 1035, 1061 (1964), with consequent "hardships ... on parties to administrative proceedings", Note, Judicial Acceleration of the Administrative Process: The Right to Relief from Unduly Protracted Proceedings, 72 Yale L.J. 574 (1963). See Long, Administrative Proceedings: Their Time and Cost Can Be Cut Down, 49 A.B.A.J. 833 (1963); Sen. Comm. on the Judiciary, 86th Cong. 2d Sess., Landis, Report On Regulatory Agencies To The President-Elect 5-9 (Comm. Print 1960).

In spite of clear Congressional intent, "[d]ecisions, however, have in general held that, as presently worded, the Administrative Procedure Act provides no remedy for failure of agencies to proceed with reasonable dispatch, see, e.g., National Labor Relations Board v. Injection Molding Co., 211 F. 2d 59, 66 (8th Cir. 1954); New Standard Publishing Co. v. F.T.C., 194 F. 2d 181 (4th Cir. 1952)"; Commission on Organization of Executive Branch of the Government, Task Force Report On Legal Services and Procedure 184-185 (1955). The "first instance in which a court in dealing with the problem of delay has relied upon section 6(a)". Note, supra, 72 Yale L.J. 577, was Deering Milliken, Inc. v. Johnston, 295 F. 2d 856 (4th Cir. 1961).

In that case, the "administrative proceedings" commenced in October, 1956, the case was remanded by the agency in December, 1957 after an April, 1957 hearing examiner's report, the examiner filed a second report in December, 1959, and the agency without decision remanded the case again in January, 1961, 295 F. 2d 857-859. Although modifying the lower court's grant of an injunction against an officer of the agency, the reviewing court squarely held that, "under §10(e) of the Administrative Procedure Act, the courts have the right and the duty to enforce the Act's requirement that the Board proceed with reasonable expedition", 295 F. 2d 863-864. In reaching this conclusion, the court stated, 295 F. 2d 861-863,

> "This [Section 6(a)] is no precatory declaration. It is an enforceable command, made expressly so by §10(e) of the Administrative Procedure Act ....
>
> ***

> "The explicit provision of §10(e) of the Administrative Procedure Act, that the courts shall compel agency action unlawfully withheld or unreasonably delayed, is an affirmative statutory declaration of the congressional purpose that the requirement of §6 of that Act ... gives rise to legally enforceable rights of the parties to the proceeding. Its formally declared intention is fully supported by the legislative history.***"

The court then concluded that, where "administrative proceedings approach their fifth anniversary" without any final adjudication thereof, the conduct of proposed further hearings on the second remand "constitutes a failure to conclude the proceedings with reasonable dispatch", and the case was remanded with directions to "promptly" conclude the proceedings, 295 F. 2d 867-869. See Texaco, Inc. v. FTC, 118 App. D. C. _____, 336 F. 2d 754, 763 (1964), petition for cert. filed, 33 U. S. L. Week 3196 (U. S. Oct. 28, 1964) (No. 635), wherein, after an investigation begun in 1952, a complaint issued in 1956, a dismissal by the Hearing Examiner in 1959, a remand by the agency in 1961, a second examiner decision in 1962, and an agency decision in 1963, this Court ordered the complaint dismissed on the grounds, inter alia, that the agency's "efforts ... have exceeded permissible limits and have had unreasonably harassing and oppressive effects" upon the respondents therein.

B. Administrative delay from the commencement of an investigation in 1954 to a final agency decision in 1964, including a six-month period when, by its former inaction the Commission lacked a quorum for such decision, is per se in violation of the statute

Recitation of the events involved in these proceedings before the Commission demonstrates a violation of the letter, as well as the spirit,

of the statute. An investigation with a view to formal proceedings was commenced by the agency at least as early as June 1954 (Cert. Tr. 17457, 17549, 17631). The formal proceedings herein commenced in 1957, involving in part matters which had occurred in 1953 (Cert. Tr. 23909, 23919, 24007). The hearings before the Hearing Examiner commenced in November 1957, and ended in January 1959 (Cert. Tr. 1-16116). He issued his recommended decision in July, 1961, two and one half years later (Cert. Tr. 24546). Oral argument was held before the Commission in March, 1962 (Cert. Tr. Doc. 1099). The Commission failed to act on the record for nearly eighteen months until one of its members left the service of the agency. For the next six months the Commission could not decide the case for lack of a quorum. A quorum was reacquired in March, 1964. Several months later the new member, who had never heard oral argument two years before joined with two out of the serving four members who did hear argument, to render a decision. (See Appendix A).

In FTC v. J. Weingarten, Inc., 336 F. 2d 687, 691 (5th Cir. 1964) petition for cert. filed, 33 U.S.L. Week 3224 (U.S. Dec. 3, 1964) (No. 736), the court recognized the Congressional intention contained in Section 6(a) of the Administrative Procedure Act but concluded, on the facts therein, that an agency order remanding the case to the Hearing Examiner did not violate that section

> "when a complaint pends for some 2 and 1/2 years before a Hearing Examiner and 11 months thereafter before the whole Commission. Absent proof of the normal time necessary to dispose of a similar proceeding or of facts tending to show a dilatory attitude on the part of the Commission or its Staff -

matters totally undeveloped on this record -
we are unable to say that a Judge can so hold. ***"

The record in the instant proceedings, however, meets the criteria established by the Court in Weingarten for a per se violation of Section 6(a) of the Administrative Procedure Act.[1/]

1. Ten years had elapsed since petitioners were first investigated by the Commission until the time of the issuance of the Commission's final decision (June, 1954 to June, 1964).

2. The period of time from the start of the proceedings to the date when the Commission's final decision was rendered involved approximately 94 months. This compares with an average of 28.6 months for similar proceedings before the Commission.

3. The period of time from the opening of the hearing to the date when the record closed involved 26 months, as compared with an average of 7.1 months for similar proceedings before the Commission.

4. The period of time from the date when the record closed to the issuance of the recommended decision involved 30 months, as compared with an average of 3.3 months for similar Commission proceedings.

5. The period of time from the date when the recommended decision was issued to the date of the final decision by the Commission involved 35 months, as compared with an average of 13.5 months for similar Commission proceedings.

1/ The comparative statistics were taken from Admin. Conf. of the U.S., Statistical Data Related To Administrative Proceedings Conducted By Federal Agencies FY 1963 272 et seq., (S. Comm. On The Judiciary, Subcomm. On Admin. Prac. and Proc. 88th Cong. 2nd Sess. Aug. 1964).

C. The delay in the proceeding below, and the administrative action thus unlawfully withheld and unreasonably delayed, constituted an illegal sanction under Section 9(a) of the Administrative Procedure Act.

Under Section 9(a) of the Administrative Procedure Act, 5 U.S.C. §1008(a), "[i]n the exercise of any power or authority ... [n]o sanction shall be imposed or substantive rule or order be issued except within jurisdiction delegated to the agency and as authorized by law". The legislative history of this section makes very clear that the sanction imposed by the Commission upon petitioners, by the inordinant delay in reaching a decision, was barred thereby.

Section 2(f) of the statute defines sanction as including "the whole or part of any agency ... (2) withholding of relief ...." With respect to Section 9(a), the legislature recognized that agencies might attempt to impose unauthorized sanctions by resort to such extra-judicial remedies as publicity and thus intended the section to apply to any and all forms of sanction resulting from agency action taken or, as in the proceeding below, withheld. Thus, S. Doc. No. 248, supra, at 274:

> "This section [9(a)] embraces both substantive and procedural requirements of law. *** In short, agencies may not impose sanctions which have not been specifically or generally provided for them to impose. ***Sanctions in the way of penalties or relief must be identified and authorized by law, and where authorized they must in any case properly apply in the factual situation presented.
>
> "One troublesome subject in this field is that of publicity, which may in no case be utilized directly or indirectly as a penalty or punishment save as so authorized. *** It

> will be the duty of agencies not to permit informational releases to be utilized as penalties or to the injury of parties."

According to the then Chairman of the House Judiciary Committee, which originated the Administrative Procedure Act, Section 9(a) has a "basic premise ... that agencies are not authorized to invent sanctions or relief or to attempt to apply or grant them beyond the limitations of authority within which they operate", ibid. at 368.

II. THE COMMISSION'S DECISION WAS VOID FOR FAILURE OF A VALIDLY CONSTITUTED QUORUM TO MAKE THE DECISION.

The record in the instant proceedings was submitted to the Commission on March 1, 1962. At this time Commissioner Frear was on the Commission and remained in the service of the Commission until September, 1963. In March, 1964, Commissioner Owens commenced his service on the Commission (See Appendix A). In June, 1964, the Commission issued its decision. Commissioners Cary, Whitney and Owens signed the decision, and Commissioners Cohen and Woodside did not participate. Commissioner Owens had not heard oral argument. With respect to him, petitioners' right to have him hear oral argument had not been waived. By not rendering a decision for eighteen months between March, 1962 and September, 1963 the Commission rendered itself thereafter unable to act for failure to possess a validly constituted quorum, Commissioners Cary and Whitney being the only two Commissioners qualified to participate in the Commission's final decision.

While petitioners waived their rights allowing Commissioner Frear to participate in a decision although absent from oral argument, no waiver was extended to Commissioner Owens. Moreover, under the rules in existence when the instant proceeding was argued, the examiner gave only a recommended decision; the petitioners were entitled as a matter of right to oral argument; and the Commission issued the decision, i.e., the initial decision, see former Rules of Practice 16(b), 17, and 21(a).[2/] Under those circumstances, petitioners had a right to have all of the Commissioners who participated in the decision hear oral argument.

In WIBC, Inc. v. FCC, 104 App. D.C. 126, 259 F. 2d 941 (1958), cert. denied, 358 U.S. 920, this Court held that, since oral argument had been requested and had not been "clearly waived" with respect to a certain FCC commissioner, such commissioner should not have voted.

2/ Rule 16(b) of the Commission's Rules of Practice, 17 C.F.R. §201.16(b) (1964), provided, in part, that "[t]he hearing officer shall prepare a recommended decision in any proceeding in which a hearing officer's decision is required under the Administrative Procedure Act ...." Rule 17, 17 C.F.R. §201.17, provides for the filing of exceptions to the recommended decision. Rule 21(a), 17 C.F.R. §201.21(a), provided that, "... upon written request of any party a matter to be decided by the Commission will be set down for oral argument before the Commission unless exceptional circumstances make oral argument impracticable or inadvisable. ***". It was not until August 1, 1964, that the Commission provided for initial decisions by the Hearing Examiner, with limited review thereof upon application to the Commission, 29 F.R. 9489.

Since his vote had been "decisive" in effecting entry of the order, the order was vacated, 104 App. D. C. 128, 259 F. 2d 943. The Court emphatically stated that "... oral argument .... had not been 'clearly waived'" when at the time of oral argument the Commissioner "was not even a commissioner at all", 104 App. D. C. 127, 259 F. 2d 942 (emphasis added). Similarly, in the instant proceedings, Commissioner Owens was not in the Commission's service at the time of oral argument. Clearly, therefore, there could be no waiver as to him. Moreover, as in the case of the absent FCC Commissioner in WIBC, Commissioner Owens' vote was the deciding vote since at least two out of the five Commissioners disqualified themselves in the case.

Where the parties "in a proceeding of a quasi-judicial character" do not waive the right to oral argument before an agency member who does not hear oral argument but renders the decision, the duty to adjudicate has not been correctly performed. Morgan v. U.S., 298 U.S., 468, 480-481:

> "*** That duty cannot be performed by one who has not considered evidence or argument. It is not an impersonal obligation. It is a duty akin to that of a judge. The one who decides must hear."

As this Court has held, Tri-State Broadcasting Co. v. FCC, 71 App. D. C. 157, 159, 107 F. 2d 956, 958 (1939):

> "*** [oral argument] might very well induce the Commission to make one finding, when, without such argument, it may have made a contrary finding. Right of argument is an indispensable step to a fair hearing. ***"

Under the procedure existing for broker-dealer cases prior to August 1964, (page 24, supra), the Commission issued the initial decision based upon only a recommended decision by the Hearing Examiner. The Commission itself - not the Examiner as at present - was the ultimate fact-finder. Where, as here, a new member of this fact-finding body comes to office and participates in the decision several years after a hearing and oral argument before the body, the participation by such a new member violated due process of law. Thereby, the agency acts "on a cold record.... years after the hearing and eight years after the alleged offense" involving, as here, the character of the licensee. Feldman v. Board of Pharmacy of D.C., 160 A. 2d 100, 103 (D.C. Munic. Ct. App. 1960), appeal denied per curiam, 108 App. D.C. 46, 279 F. 2d 821 (1960); See Brown v. D.C., 127 U.S. 579, 586 (only majority of quorum of legally constituted governmental body can act on official matters); L.B. Wilson, Inc. v. FCC, 83 App. D.C. 176, 190, 170 F. 2d 793, 807 (1948) ("'He who decides anything, one party being unheard, though he should decide right, does wrong'").

The Commission's recent decision in Isthmus Steamship & Salvage Co., Inc. et al., Sec. Exch. Act Rel. No. 7476 (Dec. 16, 1964), CCH Fed. Sec. L. Rep., Para. 77, 166, deals with a factual situation different from the instant case. In Isthmus Steamship it was held, inter alia, that participation in the decision of the Commission by a Commissioner (Commissioner Owens) who was appointed subsequent to the oral argument but had read the transcript of the oral argument and considered arguments in the briefs and evidence in the record, did not warrant a reversal of the decision.

The Commission held that the parties in that case specifically agreed that "any Commissioner at the time a decision is rendered in this case may participate therein."

However, in the instant proceeding, the then counsel for these petitioners did not enter into such "agreement". The following colloquy between Commissioner Cary, Mr. Kiernan, Miss Antell and Mr. Palmer makes this clear. (Cert. Tr., Doc. No. 1099, pp. 1-4).

> Commissioner Cary: "It is proposed that any Commissioner at the time a decision is rendered in this case who has not disqualified himself may participate therein, with the understanding that if he was not present at this oral argument, he will read the transcript. Is this agreeable to counsel?"
>
> Mr. Kiernan: "It is agreeable to McCoy and Willard."
>
> Miss Antell: "Yes".
>
> Mr. Palmer: "I beg your Honor's pardon. Ordinarily, would that mean there would be four Commissioners sitting?"
>
> Commissioner Cary: "That would mean in this particular case that, assuming all of us are still living, it would be decided by four Commissioners apart from Commissioner Woodside, who has disqualified himself." ***
>
> Commissioner Cary: "Commissioner Frear, having read the record, will participate in the decision."
>
> Mr. Palmer: "*** I am satisfied to have the absent Commissioner read the record and see the exhibits and then join in with the others." ***
>
> Commissioner Cary: "Upon your sitting down, may we assume that the Commissioner who is not present may participate in the case?"
>
> Mr. Palmer: "Yes, your honor."

The foregoing colloquy demonstrates that the then counsel did not waive petitioners' right of oral argument with respect to anyone except absent Commissioner Frear. Moreover, while an administrative hearing, including oral argument, may not be required in certain administrative proceedings, when once a hearing or oral argument is provided, due process requires that that procedure must be complied with by the agency.

III. THE STANDARD OF WILLFULNESS SOUGHT TO BE IMPOSED BY THE COMMISSION - THAT IF A RESPONDENT ACTS INTENTIONALLY IN THE SENSE THAT HE KNOWS WHAT HE IS DOING, HIS ACTION IS WILLFUL, AND THERE NEED NOT BE IN ADDITION AN INTENT TO VIOLATE THE LAW - IS WITHOUT BASIS OR WARRANT IN LAW.

Under Section 15(b) of the Securities Exchange Act of 1934, 15 U. S. C. §78o(b), the Commission, in order to revoke or suspend the registration of a broker-dealer, must make a finding that such broker or dealer, and any principal thereof, has "willfully" violated provisions of the 1934 Act or of the Securities Act of 1933. Upon a finding of willful violation by such principals, the Commission then imputes a willful violation to the broker-dealer on the grounds that the principal aided and abetted the registrant in such violation and was therefore a "cause" for such revocation. The concept of aiding and abetting is not contained in either the 1933 or 1934 Acts and appears to have been borrowed by the Commission from the Federal aider and abettor statute, see 3 Loss Securities Regulation 1476 (2d ed. 1961).[3/]

3/ 18 U. S. C. §2(a): "Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal."

A. The standard of willfulness used by the Commission is no legal standard at all and cannot be extrapolated from judicial decisions.

In its decision below, the Commission held that the individual petitioners had willfully violated the federal securities statutes because (Cert. Tr. 25130-25131):

> "... [I]f a respondent acts intentionally in the sense that he knows what he is doing, his action is willful, and ... there need not be in addition an intent to violate the law. *** We have never considered a careless disregard of the law to be necessary for a finding of willfulness. That such a situation has been found to constitute willfulness or that, as in the Hughes case, the conduct of a respondent who deliberately chose to continue a method of operation in spite of repeated warnings that it was unlawful was found willful, does not mean that either situation is the minimum required for such finding. In U.S. v. Murdock, the Supreme Court stated that 'The word ["willfully"] often denotes an act which is intentional, or knowing, or voluntary, as distinguished from accidental. *** Aid in arriving at the meaning of the word "willfully" may be afforded by the context in which it is used...'.... The remedial purpose of Section 15(b) [of the Securities Exchange Act] would be frustrated if we were required to interpret willfulness in the narrow manner urged by respondents...."

Further findings of willful violation of the Securities Act of 1933 and the Securities Exchange Act of 1934 were also made by the Commission on the basis of the foregoing alleged standard. The agency also held that the individual petitioners, by virtue of their alleged willful violation of the statutes, aided and abetted the willful violations imputed to the Registrant and were a cause, within the meaning of Section 15A(b)(4)(C) of the

Securities Exchange Act of 1934, 15 U.S, C. §78o-3(b)(4)(C), for the revocation of Registrant's registration (Cert. Tr. 25143, 25145-25146).

In Hughes v. SEC, 85 App. D. C. 56, 58, 59, 62-64, 174 F. 2d 969, 971, 972, 975-977 (1949), Respondent broker-dealer and registered investment adviser was found by the Commission to have acted willfully in that "petitioner acted simultaneously in the dual capacity of investment adviser and of broker and dealer" and "intentionally and deliberately," the former capacity requiring her to act as a fiduciary and the dual capacity creating a clear conflict of interests concerning which she had been repeatedly warned by the Commission prior to the institution of proceedings. These facts clearly established willfulness as importing more than just a knowledge that the actor knew what he or she was doing. The authority cited by this Court for the Hughes ruling is Dennis v. U.S., 84 App. D. C. 31, 34, 171 F. 2d 986, 988 (1948), affirmed 339 U.S. 162, which concerned the conviction of a well known Communist leader "for willful default in failing to answer" a lawful subpoena before a Congressional committee.

The second authority cited by the Commission below was dictum in a decision in which the Supreme Court affirmed the reversal of a conviction for alleged willful refusal to supply information concerning matters in defendant's Federal income tax return, the defendant having claimed that his answers might tend to incriminate him, U.S. v. Murdock, 290 U.S. 389, 392-393, 394-395. The court refused to give an instruction that, in determining willfulness, the jury should consider whether or not "' the reasons stated by the defendant in his refusal to answer questions were given in good

faith and based upon his actual belief'", ibid. at 394. The Murdock decision is not authority for the Commission's decision, and "until the Supreme Court itself construes 'willfully' in the SEC context, there must be a lingering doubt", 2 Loss Securities Regulation 1311 (2d ed. 1961); Note, Procedural Safeguards for Licensees: Section 9(b) of the APA, 75 Harv. L. Rev. 383, 386, 387-88 (1961). The SEC statutes are not those from which the requirement of willfulness was expressly precluded, see State v. Dobry, 217 Iowa 858, 250 N. W. 702, 704 (1933).

Even if one accepts the reasoning of the Commission and looks to the context in which willfulness is used in the Securities Exchange Act, it will be noted that the only other section of the statute in which the term is used is Section 32, 15 U. S. C. §78ff. This section provides criminal penalties for "[a]ny person who willfully violates any provision of this chapter, or any rule or regulation thereunder". The Commission position appears to be that the same word used in two separate sections of the same statute must be given different interpretations, the one under Section 32 requiring proof of actual intention to violate the statute and the other under Section 15(b) requiring proof of practically nothing at all. To its interpretation under Section 15(b), the Commission goes one step further. It borrows from criminal law the concept, without amplification therefor, that the individual respondents "aided and abetted" the Registrant in violating the statute. The Commission then makes findings with respect to these essentially criminal terms on the basis of a preponderance of the evidence, which is a rule of civil law.

These petitioners do not know what the proposition means that a finding of willfulness does not require a finding of an intent to violate and that there need only be an intent to do the act which constitutes the violation. Literally, this could mean that every act performed by a human being is willful so long as he acts knowing that he is acting. In effect, relying upon the alleged remedial purposes of the Securities Exchange Act, the Commission creates a basket rule into which any and all departures from what the agency considers, at a given moment, to be required by law can be conveniently swept and findings made and published to the world, in terms of criminal import, that certain employees of a brokerage firm willfully violated, and aided and abetted a willful violation of, the securities statutes.

The extreme, and legally dangerous, extent to which the Commission has pushed its no-concept of willfulness is demnostrated by findings in a recent decision, Life Shares Trading Corporation, Sec. Exch. Act Rel. No. 7211 (Jan. 8, 1964). In this decision revoking a broker-dealer registration, the Commission acted on respondents' consent "to findings that they willfully but 'unintentionally' violated the Securities Act of 1933 ... and the Exchange Act", the Commission noting:

> "In order to constitute a 'willful' violation, it is not necessary that respondents intend to violate the statutes but only that they intend to do the act which results in the violation. ***We construe respondents' use of the word 'unintentionally' as designed to negative an intent to violate the statute."

As one Commissioner has stated, citing SEC v. Chenery Corporation, 332

U.S. 194, 214 (dissent), "'The more you explain it [the concepts of "cause" and "willful violator"] the more I don't understand it'", American Securities Associates, Inc., Sec. Exch. Act Rel No. 7137 (Sept. 9, 1963) 3 (dissent).

Under the basket theory of willfulness implicit in the Commission's decision below, the agency in effect asks the Courts and regulated industry to permit the agency, by resort to "expertise", to decide when, if, and how this elusive theory shall be applied. Such resort to expertise cannot be a substitute for lawful, basic findings of fact and law required under Section 8(b) of the Administrative Procedure Act, 5 U.S.C. §1007(b). On the contrary, the Supreme Court has stated that "... expertise is not sufficient by itself. Findings supported by substantial evidence are required". ICC v. J-T Transport Co., 368 U.S. 81, 93; Commissariat a L'Energie Atomique v. Watson, 107 App. D.C. 85, 87-88, 274 F. 2d 594, 596-597 (1960) ("explicit findings" required even where agency possesses "large measure of discretion"). Taken in their entirety, the concepts of willfulness, aiding and abetting, and cause applied by the Commission in the decision below can only leave the Court with the view that, "while we know... the [agency's]... ultimate conclusion ..., we are not sure of the basis on which it rested that conclusion", Northeast Airlines, Inc. v. CAB, 331 F. 2d 579, 588 (1st Cir. 1964). Courts cannot decide by, and an absence of required basic findings can only lead to, speculation. United States v. Chicago M., St. P. & P.R. Co., 294 U.S. 499, 511; Berko v. SEC, 297 F. 2d 116, 118-119 (2d Cir. 1961). The absence of required findings is fatal to the validity of an administrative decision, regard-

less of whether there may be evidence in the record to support proper findings. Anglo-Canadian Shipping Co., Ltd. v. FMC, 310 F. 2d 606, 613, 615-616 (9th Cir. 1962), citing with approval this Court's decision to the same effect in Saginaw Broadcasting Co. v. FCC, 68 App. D. C. 282, 287, 96 F. 2d 554, 559 (1938), cert. denied, 305 U. S. 613.

Further, the vague standard of willfulness employed by the Commission "attempts to categorize, in advance, every willful and knowing or grossly negligent violation as having the required nature [to justify a finding of civil violation of statute]. The proposition is so easily reducible to an absurdity as to be clearly untenable. *** To permit any such result ... would be to punch a hole as wide as a barn door in the restrictions imposed by the Congress upon the authority of the ... [agency]." Shay v. Agric. Stab. and Conserv. State Com. for Ariz., 299 F. 2d 516, 522 (9th Cir. 1962).

B. The holding that individual petitioners aided and abetted Registrant in violating the statute is not based upon basic findings required by law.

One of the grounds for revoking or suspending the registration of a broker-dealer under the Securities Exchange Act of 1934 is that "any person associated with such broker or dealer ... has willfully violated" the Securities Act of 1933, Section 15(b)(5)(D), 15 U. S. C. §78o(b)(D). The words "aid and abet" were brought into the statute by the addition of a new Section 15(b)(5)(E), effective August 20, 1964, Pub. L. 88-467, 78 Stat. 574, which provided for an additional grounds of revocation where any person associated with a broker or dealer "has willfully aided, abetted, counseled,

commanded, induced, or procured "any violation of the Securities Act of 1933 by such broker or dealer. This provision was not, however, applicable to petitioners herein under the wording of the statute prior to August 1964.

The concept of aiding and abetting is "a rule of criminal responsibility for acts which one assists another in performing", Nye & Nissen v. U.S., 336 U.S. 613, 620 (rule "makes a defendant a principal when he consciously shares in any criminal act"). However, just what is the theory of aiding and abetting applied by the Commission is not explained by the agency in its decision. This failure to make required basic and underlying findings renders the decision below void under Section 8(b) of the Administrative Procedure Act.

IV. THE COMMISSION LACKED JURISDICTION IN THIS PROCEEDING TO FIND THAT ONE OF THE INDIVIDUAL PETITIONERS, AS A DIRECTOR OF AN ISSUER AND NOT AS A PRINCIPAL OF REGISTRANT, UNLAWFULLY PERMITTED A FALSE REGISTRATION STATEMENT TO BE FILED BY SUCH ISSUER

In its order for proceedings below, the Commission alleged that one of the individual petitioners willfully violated Section 7 of the Securities Act of 1933, 5 U.S.C. §77g. by permitting a false registration statement to be filed with the agency. This petitioner was a director of National Lithium Corporation, and Registrant was the underwriter for the National Lithium stock offering involved. After the corporation filed a registration statement in February 1957, the Commission instituted stop-order proceedings which tracked the broker-dealer revocation proceedings under review here. The agency issued its decision in the stop-order proceeding in 1961, 40 S.E.C. 746 (1961), wherein it held, in part, that National

Lithium's "officers and directors should at least have been aware" of certain deficiencies in the facts underlying, and the statements made in, the registration statement, 40 S.E.C. 766. Over the objection of petitioners, the record in the stop-order proceedings was incorporated in the record herein (Cert. Tr. 25148). In the decision herein the Commission held that the individual petitioner had violated Section 7 not as a principal of Registrant but as a director of National Lithium (Cert. Tr. 25149, n. 38):

> "In view of the fact that ... [Registrant], as the underwriter, was not cited in the order for proceedings with respect to the deficiencies in the National Lithium registration statement, ... Gearhart's responsibility, to the extent it is based on his position as a principal in the underwriter, is not before us."

Section 7 of the Securities Act requires that certain information be furnished in a registration statement pursuant to rules of the Commission issued thereunder. A willful violation of this section, in the true criminal sense, might subject the person involved to criminal liability under Section 24 of the Act, 15 U.S.C. §77x. Further, the statute provides that directors responsible for false registration statements may be civilly liable to persons acting in reliance thereupon under very limited circumstances and statutes of limitation not exceeding two years, Sections 11, 12, and 13, 15 U.S.C. §§77k, 77l, and 77m. No statutory or other legal basis exists for the Commission's fashioning Section 7 into a new legal weapon against broker-dealers and their principals. This section serves merely to implement the anti-fraud provisions of Section 5 of the Act, 5 U.S.C. §77e, with respect to which the law clearly provides for violation thereof. Indeed,

according to one authority, the only circumstances in which Section 7 has been used as the basis for a claimed statutory violation involved "a relatively recent consent injunction case" in which "the Commission included counts under §§7 and 10, which have to do with the content of the registration statement and prospectus", 1 Loss, Securities Regulation 180-181, n. 3; see 184 (2d ed. 1961). The individual petitioner herein may have been civilly liable to stockholders of National Lithium. However, he has not violated Section 7, because Section 7, by its terms and purport, cannot be violated as a matter of law. Creation of this alleged violation constitutes an unauthorized sanction forbidden by Section 9(a) of the Administrative Procedure Act (pp. 22 et seq., supra).

When the decision herein was issued in 1964, the Commission already had made up its mind that the individual petitioner violated Section 7 by virtue of its finding in the 1961 stop-order proceeding. On these grounds alone, the holding with respect to the Section 7 violation should be rejected. Texaco, Inc. v. FTC, supra, 336 F. 2d 759-760. If the Commission had any jurisdiction over the individual petitioner as a director of National Lithium, it had that jurisdiction in the stop-order proceeding. It lacked that jurisdiction in the broker-dealer proceeding. The finding in 1964 was therefore void.

V. ALTHOUGH ANY ONE OF THE FOREGOING ERRORS OF LAW WARRANTS REVERSAL OF THE COMMISSION'S ORDER BELOW, THE CUMULATIVE EFFECT THEREOF DENIED PETITIONERS A FAIR HEARING AND IMPERATIVELY COMPELS A REVERSAL OF THE ORDER

Whatever the legal label for a broker-dealer proceeding, the

practical effect of such an accusatory hearing is to subject the individual petitioners herein, and the Registrant, to a continuing and severe sanction. Even the Commission in its decision implies that such a sanction exists (Cert. Tr. 25157). Such acknowledgment is standard in similar agency proceedings, e.g., Sutro Bros. & Co., Sec. Exch. Act Rel. No. 7053 (April 10, 1963) 12. The fact is that broker-dealer disciplinary proceedings are "'highly penal in nature'", Abrams v. Daugherty, 60 Cal. App. 297, 212 Pac. 942, 945 (1922); SEC v. Glass Marine Industries, Inc., ___ F. Supp. ___ (D. Del. 1962), CCH Fed. Sec. L. Rep., para. 91, 169, p. 93, 844 ("SEC comes to this case as accuser; *** ... [T]he civil sanctions of the Securities Act are punitive, even quasi-criminal"); See Gilchrist v. Bierring, 234 Iowa 899, 14 N. W. 2d 724, 731 (1944).

Any of the errors described above is sufficient ground to reverse the Commission's order. Unquestionably, the cumulative effect of these errors compels reversal of the order below, occurring as they did in an accusatory proceeding where scrupulous regard for due process of law should be observed. Cf. Carter Products, Inc. v. FTC, 201 F. 2d 446, 454 (9th Cir. 1953), vacated per curiam, 346 U.S. 327 (remanded for further proceedings). Due process of law has been denied the petitioners in a proceeding marked by what one court has called the "penal aspect", Pike v. CAB, 303 F. 2d 353, 357 (8th Cir. 1962) ("lack of specificity" and "drastic" effect depriving respondent pilot of "his primary means of livelihood"); See Barrese v. Ryan 203 F. Supp. 880, 886 (D. Conn. 1962) (overruling BIA decision which reads "into statute language which is not there"); Schneider v. Rusk, 377 U.S. 163, 169 ("second class citizenship").

CONCLUSION

The errors commited by the Commission below are not technical violations of statute and due process which deserve no judicial intervention by this Court. Delay in adjudication contrary to Section 6(a) of the Administrative Procedure Act, the failure to adjudicate in accordance with agency rules and law with respect to oral argument and the right to a hearing, the basket concepts of willfulness, aiding and abetting, and cause, and the newly created sanction under Section 7 of the Securities Act - all of these have an effect upon thousands of members of the securities industry regulated by the Commission.

For example, at the end of fiscal year 1963, the Commission had on file 5,482 effective registrations of brokers and dealers. During that fiscal year the agency dealt with 259 proceedings to deny and revoke registration and to suspend and expel from membership in a securities exchange or association; one hundred and thirty-nine such proceedings were pending at the end of that fiscal year, 1963 SEC 29th Ann. Rep. 56-59. Every one of the foregoing licensees or proceedings involved the application by the Commission of the concepts of willfulness, aiding and abetting, and cause which are before this Court.

Because of the Commission's serious violation of the reasonable dispatch requirements of the Administrative Procedure Act, as well as the other substantial denials of due process in the proceedings and errors in the decision below, the Commission's order should be dismissed. At the very least, the Court should remand the case to the agency for the expeditious conduct of a

new proceeding in accordance with law. Such a remand is not an academic exercise. These petitioners, as well as thousands of others so regulated, have the right to be regulated by reasonably expeditious and wholly fair administrative procedures, applying established or reasonably ascertainable standards of conduct. Such was not the case here, and, as this brief has demonstrated, many of the challenged acts are common to broker-dealer proceedings.

Thus, a "doubt can be raised" as to authority of the Commission to develop the concepts of willfulness, aiding and abetting, and cause used below and to the failure of the agency to underpin these concepts with the findings required by Section 8(b) of the Administrative Procedure Act. A "remand to the Commission [with respect thereto] is not purely academic for the sake of procedural regularity." Gilbertville Trucking Co. v. U. S., 371 U.S. 115, 131. "Because this case raises substantial questions, and we believe clarification necessary", the case should be remanded, Berko v. S.E.C., supra, 297 F. 2d 118.

Respectfully submitted,

CHARLES S. RHYNE
EDWARD D. COXEN, JR.
COURTS OULAHAN

Rhyne & Rhyne
839 17th Street
Washington, D. C.

February 15, 1965

APPENDIX A

SECURITIES AND EXCHANGE COMMISSION

MEMBERS OF COMMISSION
1960 TO AUGUST 1964

Name	From	To
Andrew Downey Orrick	May 26, 1955	July 15, 1960
Harold C. Patterson	August 5, 1955	November 29, 1960
Ebal F. Hastings	March 11, 1956	August 31, 1961
James C. Sargent	June 29, 1956	October 21, 1960
Edward N. Gadsby	August 20, 1957	August 4, 1961
Byron D. Woodside	July 18, 1960	Now in office
Daniel J. McCauley	October 24, 1960	March 26, 1961
J. Allen Frear, Jr.	March 15, 1961	September 30, 1963
William L. Cary	March 27, 1961	August 20, 1964
Manuel F. Cohen	October 11, 1961	Now in office
Jack M. Whitney, II	November 9, 1961	June 15, 1964
Hugh F. Owens	March 23, 1964	Now in office
Hamer H. Budge	July 8, 1964	Now in office

Source: Securities and Exchange Commission, Office of the Secretary

BRIEF FOR RESPONDENT

UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18,817

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR., and EDWARD V. OTIS,

Petitioners

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR REVIEW OF ORDER OF SECURITIES AND EXCHANGE COMMISSION

PHILIP A. LOOMIS, JR.,
General Counsel

WALTER P. NORTH,
Associate General Counsel

ROY NERENBERG,
Attorney

Securities and Exchange Commission
Washington, D. C. 20549

STATEMENT OF QUESTIONS PRESENTED

In the opinion of the respondent the questions are:

(1) Whether petitioners' failure to comply with Section 25(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78y(a), and to exhaust their administrative remedies preclude petitioners from objecting that the Securities and Exchange Commission (Commission) failed to proceed with "reasonable dispatch" and that an invalidly constituted quorum of the Commission decided the case.

(2) Assuming that the question were properly raised, whether the Commission proceeded with "resonable dispatch" as required by Section 6(a) of the Administrative Procedure Act, 5 U.S.C. 1005(a), in the proceedings herein under review and whether dismissal of the proceedings at this stage after they have been completed is, in any event, an appropriate remedy for alleged undue delay.

(3) Assuming that the question were properly raised, whether a legally constituted quorum of the Commission decided the proceedings herein under review.

(4) Whether the Commission correctly held that intentional acts in violation of the securities laws were "willful" under Section 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b), and that certain violations of Section 15(c)(1) of the Exchange Act 15 U.S.C. 78o(c)(1) were "aided and abetted" by the individual respondents.

(5) Whether in proceedings for revocation of the registration of a broker-dealer pursuant to Section 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b), the Commission may find as a basis for revocation that a principal of such broker-dealer willfully violated Section 7 of the Securities Act of 1933, 15 U.S.C. 77g.

INDEX

CITATIONS

Cases:

* Cases or authorities chiefly relied upon are marked by asterisks.

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Respondent

PETITION FOR REVIEW OF ORDER OF
SECURITIES AND EXCHANGE COMMISSION

BRIEF FOR RESPONDENT

COUNTER STATEMENT OF THE CASE

Nature of Proceeding

Petitioners, Gearhart & Otis, Inc., Frederick D. Gearhart, Jr., and Edward V. Otis, seek review pursuant to Section 25(a) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78y(a), of an order of the Securities and Exchange Commission (Commission) dated

June 2, 1964, (Doc. No. 1079, pp. 38-39)[1/] which revoked pursuant to Section 15(b) of the Exchange Act, 15 U.S.C. 78o(b), the registration as a broker and dealer in securities of Gearhart & Otis, Inc.; expelled Gearhart & Otis, Inc., from membership in the National Association of Securities Dealers, Inc. (N.A.S.D.) pursuant to Section 15A of the Exchange Act, 15 U.S.C. 78o-3; and found Gearhart and Otis each individually to be a cause of such revocation and expulsion. In its Findings and Opinion (Doc. No. 1079, pp. 1-37) the Commission held that petitioners willfully violated Section 5(a)(1) and 5(a)(2) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77e(a)(1) and 77e(a)(2), in the sale of shares of stock of Air America, Inc.; that Gearhart & Otis, Inc., together with or aided and abetted by Gearhart and Otis, willfully violated Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), Sections 10(b) and 15(c)(1) of the Exchange Act, 15 U.S.C. 78j(b) and 78o(c)(1), and Rules 10b-5 and 15c1-2 thereunder, 17 C.F.R. 240.10b-5 and 17 C.F.R. 240.15c1-2, by using an offering circular which was found to be false and misleading, in the offer and

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1/ "Doc. No. ," refers to the certificate listing and describing the record in proceedings before the Commission filed with the Court on October 15, 1965. "Br. ," refers to petitioners' brief.

sale of Series B certificates and common stock of Air America, Inc.; that Gearhart willfully violated Section 7 of the Securities Act, 15 U.S.C. 77g, by participating in the preparation of and supplying information for the registration statement of National Lithium Corporation which was found to be false and misleading; that petitioners willfully violated Section 5(a) and 5(c) of the Securities Act, 15 U.S.C. 77e(a) and 77e(c), by participating in a distribution of unregistered stock of National Lithium Corporation; and that petitioners willfully violated Sections 5(a)(1) and 5(a)(2) of the Securities Act in connection with the sale and delivery of unregistered common stock of American States Oil Company.

Facts:

Petitioner, Gearhart & Otis, Inc., became registered with the Commission as a broker-dealer in 1949 and was a member of the N.A.S.D. During pertinent periods under consideration Gearhart was president, a director, and 50% stockholder, and Otis was vice-president, a director, and 50% stockholder of Gearhart & Otis, Inc.

The Commission's revocation of the registration of Gearhart & Otis, Inc. was based upon a number of separate violations of the federal securities laws. Since, as noted below, petitioners do not deny that these violations occurred, and generally do not question the Commission's findings of fact with respect to them, we merely summarize the facts as found by the Commission.

Air America, Inc.

In 1952, one Miller, the president of Air America, Inc., resigned and was required to divest himself of his controlling stock interest. William D. McCoy of McCoy & Willard 2/ was made trustee of that stock. Thereafter, pursuant to Miller's instructions McCoy disposed of a substantial number of shares some of which were acquired by petitioners. Most of those shares were immediately resold by petitioners to the firm of McCoy & Willard, not as trustee, for subsequent resale. Petitioners made additional purchases and sales and participated in the distribution of additional shares thereby enlarging the group of purchasers who acquired the stock for resale. In 1954, Miller reacquired the shares which still remained in trust and directly and through an assignment to Air America, Inc. sold them to petitioners. Petitioners sold a substantial portion of those shares to certain individuals and to McCoy & Willard, each of whom resold the shares so acquired. No registration statement was filed with the Commission with respect to any distribution of Air America, Inc. stock. (Doc.No.1079 pp.4-11).

2/ The proceedings against petitioners were consolidated with similar proceedings against McCoy & Willard for their activities in connection with the described securities and transactions. McCoy & Willard did not seek review of the Commission's order revoking their registration as a broker-dealer.

In 1953, a Regulation A offering was made of $300,000 of Series B equipment trust certificates of Air America, Inc. The offering circular used by petitioners in the offer and sale of those securities contained false and misleading information, inter alia, regarding the fact that the bulk of the "current assets" shown on the balance sheet represented accounts receivable of doubtful collectability, and mostly past due; regarding the intended use of the proceeds of the offering; and regarding the company's failure to pay certain tax obligations. Gearhart and Otis were both personally active in the sale of certificates. Gearhart who was intimately familiar with the company's developments participated in many decisions and actions involving the company. Indeed, he even advanced funds to it to pay dividends creating the false impression that the company was financially able to pay dividends. In addition, in connection with certain sales of common stock by petitioners to a retail broker-dealer Gearhart supplied materially misleading information which the dealer in turn used in selling the stock to his customers. (Doc. No.1079 pp. 11-24).

National Lithium Corporation

The organization of National Lithium Corporation and its acquisition of certain mineral claims were effected pursuant to a contract to which petitioners were a party and for which Gearhart was primarily responsible. Gearhart was a director of the company and signed the registration statement filed in February 1957, the effectiveness of which was subsequently suspended by the Commission on

findings that it contained misleading statements and omitted required facts.[3/] Gearhart was more familiar than anyone with the company's promotion and preliminary financing, and knew or should have known of matters not disclosed or not adequately disclosed in the registration statement. In addition, prior to the filing of the registration statement, the company had begun an extensive distribution of its stock through petitioners, who had offered and sold several million shares. Petitioners also circulated articles discussing lithium to 3,000 securities dealers designed to awaken interest in lithium securities which could thereafter be focused on the company's stock. (Doc.No.1079 pp. 24-31).

American States Oil Company

During 1954 and 1955, petitioners acquired more than one million shares of American States Oil Company stock from a person who controlled the company through persons who appeared to be his nominees which were resold to other dealers and to the investing public. No registration statement had been filed with respect to those securities.[4/] (Doc. No. 1079 pp. 31-35).

3/ 40 S.E.C. 746 (1961). By stipulation the record in that proceeding was made a part of the record in the proceedings herein under review. See infra p.38 of this brief.

4/ Section 5 of the Securities Act, 15 U.S.C. 77e, requires registration for the public sale of securities acquired from a person who controls the issuer. Petitioners claimed that they did not know that their vendor controlled the company. They were, however, on notice that he might be in control.

SUMMARY OF ARGUMENT

Petitioners' objections to the Commission's order are based almost wholly on alleged procedural defects. They do not appear to deny either that the serious and extensive violations of the securities laws found by the Commission in fact occurred, or that the Commission's findings as to these violations were supported by substantial evidence.

Petitioners' urge two main procedural objections, neither of which was raised before the Commission as is required by Section 25(a) of the Exchange Act, 15 U.S.C. 78y(a): first, that the proceedings were unduly delayed and, second, that Commissioner Owens could not participate in the decision.

Petitioners were not prejudiced by delay, however, which merely postponed the revocation of registration that could be expected to result from clearly established violations; indeed, petitioners had every incentive to postpone the evil day and, as we show later, they were responsible for much of the delay. Similarly, petitioners' contentions as to Commissioner Owens' inability to participate would, if accepted, mean that in this and presumably in other protracted cases the Commission would become unable to discharge its functions and responsibilities by reason of the turnover among members of the Commission [See Appendix A to petitioners' brief, Br. 41]. Moreover, no prejudice to petitioners is shown from Commissioner Owens' participation, since the

Commission's opinion was unanimous, and the fact that he read the transcript of the oral argument instead of listening to it cannot, under the circumstances of this case, have damaged petitioners.

Petitioners' contentions with respect to the merits appear to be limited to (1) an effort to overturn the Commission's established and judicially approved definition of the term "willful" as used in Section 15(b) of the Exchange Act, 15 U.S.C. 78o(b), (2) a suggestion that the owners and managers of this two-man corporation who caused it to do various things cannot be held to have aided and abetted it in the resulting violations, and (3) the ingenious but specious suggestion that a violation of the Securities Act committed by Gearhart in his capacity as officer of an issuer is not a violation of the Securities Act by him for purposes of Section 15(b) of the Exchange Act, and that in any event filing a false registration statement does not violate the Securities Act for any purpose other than criminal prosecution. There is no basis for any of these contentions.

ARGUMENT

I. PETITIONERS' FAILURE TO COMPLY WITH SECTION 25(a) OF THE EXCHANGE ACT AND TO EXHAUST THEIR ADMINISTRATIVE REMEDIES PRECLUDE PETITIONERS FROM OBJECTING THAT THE COMMISSION FAILED TO PROCEED WITH "REASONABLE DISPATCH" AND THAT AN INVALIDILY CONSTITUTED QUORUM OF THE COMMISSION DECIDED THE CASE.

Petitioners' objections that the Commission failed to proceed with "reasonable dispatch" and that a properly constituted quorum

of the Commission did not decide the case were not presented to the Commission. Accordingly, under Section 25(a) of the Exchange Act, 15 U.S.C. 78y(a), and under the judicial doctrine of exhaustion of administrative remedies, petitioners are precluded from asserting those objections before this Court.

Section 25(a) of the Exchange Act, which confers jurisdiction upon Courts of Appeals, provides in pertinent part that:

> No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission.

This is a common provision in federal regulatory statutes [5/] and is the embodiment of the basic idea of exhaustion of administrative remedies. See generally, 2 Davis, Administrative Law § 20.06. Unlike some other review statutes, [6/] Section 25(a) does not provide that an objection not raised may be preserved upon showing reasonable grounds for failure to do so. The requirement of Section 25(a) has been construed by this Court to mean that unless the objection was raised or urged before the Commission it may not be considered on review and that the petition for review must on that basis be dismissed. Stanford Corporation v.

5/ E.g. Section 9(a) of the Securities Act of 1933, 15 U.S.C. 77i(a); Section 24 of the Public Utility Holding Company Act, 15 U.S.C. 79(a); Section 10 of the Fair Labor Standards Act, 29 U.S.C. 210; Section 10(e) of the National Labor Relations Act, 29 U.S.C. 160(e).

6/ E.g. Section 43(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-42(a); Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r; Section 10(e) of the National Labor Relations Act, 29 U.S.C. 160(e).

Securities and Exchange Commission, unreported, No. 18,166 (C.A. D.C., 1963); Wallach v. Securities and Exchange Commission, 93 App. D.C. 41, 206 F. 2d 486 (1953); Halstead v. Securities and Exchange Commission 86 App. D.C. 352, 182 F. 2d 660, 669-70 (1950) cert. den. 340 U.S. 834. Cf. R. A. Holman & Co. v. Securities and Exchange Commission, App. D.C. , 339 F. 2d 752 (1964); Securities and Exchange Commission v. R. A. Holman & Co., 116 App. D.C. 279, 323 F. 2d 284 (1963) cert. den. 375 U.S. 943 and see Gilligan, Will & Co. v. Securities and Exchange Commission, 267 F. 2d 461, 462, 468 (A.A. 2, 1959) cert. den., 361 U.S. 296, and Lile v. Securities and Exchange Commission, 324 F. 2d 772, 773 (C.A. 9, 1963). In the last cited case it was held that Section 25(a) operates as an express limitation upon jurisdiction of the court.

Even in the absence of a statutory provision such as Section 25(a) the judicial doctrine of exhaustion of administrative remedies prevents judicial review until administrative remedies are exhausted.

> [O]rderly procedure and good administration require that objections to the proceedings of an administrative agency be made while it has opportunity for correction in order to raise issues reviewable by the courts. . . Simple fairness to those who are engaged in the tasks of administration, and to litigants, requres as a general rule that courts should not topple over administrative decisions unless the administrative body not only has erred but has erred against objection made at the time appropriate under its practice. United States v. Tucker Truck Lines, 344 U.S. 33, 37 (1952).

Accord, Joseph E. Segram & Sons, Inc. v. Dillon, App. D.C. , F.2d (1965); California Interstate Telephone Company v. Federal Trade Commission, Interstate Telephone Company v. Federal Trade Commission, App. D. C. , 328 F. 2d 556 (1964). And see Patsis v. Immigration and Naturalization Service, 337 F. 2d 733, 738 (C.A. 8, 1964), where it was specifically held that failure to raise the question of delay before the agency precluded consideration of that question on appeal.

Petitioners could have urged the Commission's asserted failure to proceed with "reasonable dispatch" not only in their briefs and oral argument to the Commission on the exceptions to the hearing examiner's recommended decision but also at any stage of the proceedings when they believed the Commission to have been proceeding too slowly.[7/] Petitioners having failed to do so may not raise the issue here.

Similarly, with respect to the objection that, because petitioners allegedly did not waive oral argument as to Commissioner Owens who participated in the decision, a properly constituted quorum did not decide this matter, petitioners could have urged this objection before the Commission by way of a petition for rehearing,[8/] when re-argument orally before the Commissioners participating in the decision could have been

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7/ See Deering Milliken v. Johnston, 295 F. 2d 856 (C.A. 4, 1961), discussed page 13 infra. Rules 11 and 12 of the Commission's Rules of Practice 17 CFR 201.11-12, contain provisions for the filing of motions to the Commission and to the hearing examiner and for appeals from the latter's decisions to the Commission.

8/ Rule 21 of the Commission's Rules of Practice, 17 CFR 201.21.

provided. Although Section 10(c) of the A.P.A.,5 U.S.C. 1009(c), provides that agency action otherwise shall be final for judicial review whether or not reconsidertion is sought, where the matter to which objection is urged arises only after the agency's decion, agency reconsideration is necessary before resort to the courts in order to satisfy the requirement of Section 25(a). This exception is implicit in Section 10(c) of the A.P.A. which is operative "except as otherwise required by statute." See also 3 Davis, Administrative Law § 20.09 and see Attorney General's Manual on the Administrative Procedure Act 104 (1947) :

> [I]t would seem that under the common statutory provision that no objection to agency action not urged before the agency shall be considered by the courts, an application for agency reconsideration remains a prerequisite to obtaining judicial review of such an objection. [Emphasis supplied.]

We do not question that the order appealed from is reviewable by this Court - which is all that Section 10(c) requires; we submit, however, that this is a completely distinct question from what issues may be considered on review of that order.

As we have indicated, had the petitioners filed a petition for rehearing and had the Commission believed there might be merit to petitioners' contention, it could have ordered re-argument and thus avoided all need for court review of that issue. Indeed, even if the Commission viewed petitioners' contention as without merit, it could still have ordered re-argument and thereby obviated resort to the courts.

For the foregoing reasons, the petition for review as to petitioners' procedural objections should be dismissed without consideration of the merits.

II. THE COMMISSION ACTED WITH "REASONABLE DISPATCH" AS REQUIRED BY SECTION 6(a) OF THE A.P.A.

There is no merit to petitioners' claim that by reason of the Commission's alleged failure to act with "reasonable dispatch" as required by Section 6(a) of the A.P.A., 5 U.S.C. 1005(a), the sanction imposed by the Commission upon petitioners is unlawful. The principal purpose of the requirement of "reasonable dispatch" in Section 6(a) of the A.P.A. is to prevent agencies from, in effect, denying relief "by mere inaction" (S. Rep. No. 752, Administrative Procedure Act Legislative History, 205 S. Doc. No. 248, 79th Cong., 2d Sess. (1944-46)) or otherwise proceeding "in a dilatory fashion to the injury of the persons concerned." (H.R. Rep. No. 1980, Administrative Procedure Act Legislative History, supra, 264.) Here petitioners sought no relief. If anyone was prejudiced by the delay, it was the Commission and the public interest. Delay merely enabled petitioners to continue in business for a longer time.

Petitioners rely on Deering Milliken, Inc. v. Johnston, 295 F. 2d 856 (C.A. 4, 1961), where it was held that a party can ask the agency for expedition and, if that is unavailing, can seek judicial relief under Section 10(e) of the A.P.A., 5 U.S.C. 1009(e), in the form of an order requiring the agency to proceed expeditiously or to omit procedural steps regarded as dilatory. Neither that case nor any other case cited by petitioners suggests that a

private party can sit back until a proceeding has ultimately been completed and then invalidate the final decision on account of delay.

Petitioners appear to recognize that it would probably strike this Court as anomalous that the public purposes of the statute be frustrated through dismissal of the proceedings merely because of delay under these circumstances and accordingly, make the rather incredible suggestion that the proceedings be remanded for "the expeditious conduct of a new proceeding" (Br. 39-40). This clearly would produce substantial additional delay and makes it obvious that petitioners are not really concerned with delay and indeed, prefer more of it, unless they can somehow procure dismissal of the proceedings notwithstanding the substantial violations shown by the record.

Petitioners' statistical test for the mechanical application of Section 6(a) of the A.P.A., i.e., if a particular proceeding took substantially longer than the average time for similar proceedings, then it must be dismissed under Section 6(a), is contrary to the decided cases. An agency's complicance with the directive of Section 6(a) of the A.P.A. to proceed with "reasonable dispatch" is incapable of being measured by any fixed, inflexible standard. See Deering Milliken v. Johnston, supra, 295 F. 2d at 867. Moreover, vigorously contested proceedings obviously take more time than the decision of an undisputed matter. Berkshire Knitting Mills v.

National Labor Relations Board, 139 F. 2d 134, 136 (C.A. 3, 1943). Delays in other cases where the statute sets no time limit within which the agency must render its decision have been held to be justified by the circumstances, including the voluminous record. See, e.g., National Labor Relations Board v. Isthmian S.S. Co., 126 F. 2d 598 (C.A. 2, 1942). As the Court of Appeals for the Eighth Circuit recently said in Federal Trade Commission v. Weingarten, 336 F. 2d 687, 693 (C.A. 5, 1964) cert. den., U.S. , 33 U.S.L. Week 3285 (March 2, 1965) (No. 736):

> [I]t would be the extremely rare case where a Court would be justified in holding - as Weingarten urges us to do here - that the passage of time and nothing more presents an occasion for the peremptory intervention of an outside Court in the conduct of an agency's adjudicative proceedings.

None of petitioners' authorities hold that delay alone, accompanied by no prejudicial circumstances, warrants invalidation of an administrative proceeding already concluded. In this connection we note that in Texaco Inc. v. Federal Trade Commission, App. D.C. , petition for cert filed 33 U.S. L.Week 3196 (U.S. Oct. 28, 1964) (No. 635) 336 F. 2d 754 (1964), this Court found bias on the part of the agency and lack of substantial evidence to support the agency's decision as well as inordinate delay.

Clearly where the petitioners could have avoided delay reversal is unwarranted. See Berkshire Knitting Mills v. National Labor Board, supra; National Labor Relations Board v. Isthmian S.S. Co., supra; National Labor Relations Board v. J. G. Boswell Co., 136 F. 2d 585 (C.A. 4, 1943).

The major portions of the delay involved in this case can be attributed to petitioners' own conduct. For example, prior to the commencement of the hearing, [9/] petitioners made the following pre-trial motions:

> Motion for more definite statement (Doc. No. 863);
> Motion for production of investigative testimony and reports (Doc. No. 872);
> Motion for postponement of hearing (Doc. No. 878).

The hearings in this matter were held on 95 separate days commencing on November 18, 1957 through January 7, 1959, in New York City, Los Angeles, California, and Washington, D.C.

During the course of the hearings, petitioners made the following motions:

> Motion that public proceedings be changed to private proceedings (Doc. No. 896);
> Motion for an order directing the Commission to produce pre-hearing statements, reports and other material not yet produced (Doc. No. 909);
> Motion requesting the appointment of another hearing examiner and another attorney to represent the Division (Doc. No. 920);
> Motion requesting the production of certain material in connection with the private investigation (Doc. No. 931);
> Motion requesting the issuance of a subpoena (Doc. No. 933);

9/ The proceedings under review were commenced in August of 1957 (Doc. No. 845). Petitioners erroneously suggest (Br. 21) that the proceedings commenced with the Commission's investigation in 1954. The private investigation pursuant to Section 21(a) of the Exchange Act, 15 U.S.C. 78u(a) was of course separate and distinct from revocation proceedings under Sections 15(b) and 15A of the Exchange Act.

Motion by petitioner Gearhart for a more definite statement of the charges against him (Doc. No. 934);
Petition to vacate the Commission's amending order of January 8, 1958 (Doc. No. 952);
Motion for adjournment of hearings to take certain testimony (Doc. No. 972).

In addition, petitioners instituted proceedings in the United States District Court for the District of Columbia seeking an order of that court to vacate certain orders of the Commission and an order directing oral examination of certain employees of the Commission.[10/] Those proceedings were dismissed for lack of jurisdiction.

Post-hearing motions by petitioners included the following:

Motion requesting certain testimony (Doc. No. 978);
Motion directing counsel for the Division to answer questions (Doc. No. 979);
Motion for issuance of certain subpoenas (Doc. No. 980);
Motion to vacate Commission's order instituting proceedings or for new hearing examiner and renewal of proceedings (Doc. No. 989);
Motion for a decision on the application to withdraw registration statement of National Lithium (Doc. No. 990);
Request for sixty-day extension of time for filing of proposed findings and filing of brief (Doc. No. 994);
Request for further extension of time for filing proposed findings (Doc. No. 997);
Request for extension for filing reply briefs (Doc. No. 1000);

10/ Gearhart & Otis, Inc. v. Securities and Exchange Commission, unreported, Civil No. Misc. 27-58 (D.D.C., April 13, 1959), appeal dismissed per curiam, unreported No. 15064 (C.A. D.C., September 8, 1959).

Further request for extension of time to file reply brief (Doc. No. 1008);
Request that certain affidavit be made part of record and that hearing be reopened for additional testimony (Doc. No. 1019);
Petition for order directing the hearing examiner to reopen hearings and permit additional testimony (Doc. No. 1025).

The Recommended Decision by the Hearing Examiner was filed on July 26, 1961. (Doc. No. 1044) Thereafter, the following requests were made by petitioners:

Requests for extensions for filing exceptions to recommended decision (Doc. Nos. 1044, 1045, 1047);
Motion to reopen the proceedings and for an extension of time to file exceptions to recommended decision (Doc. No. 1052);
Further motion for extension for filing exceptions to recommended decision (Doc. No. 1057);
Further request for extension to file exceptions (Doc. No. 1060);
Request for further extension for filing exceptions (Doc. No. 1064);
Additional request for extension of time for filing exceptions (Doc. No. 1066);
Motion to hold in abeyance oral argument until proceedings can be reopened (Doc. No. 1074).

The foregoing describes only the motions and requests made by the petitioners who are now before this Court. Additional motions and requests were made before the Commission by other respondents in the consolidated proceedings who have not sought review in this Court. Each of these motions and requests required that the Commission devote its time to deliberation and disposition of these matters. Moreover, the sheer volume and size of the record which

consists of over 16,000 pages of testimony and many thousands of pages of exhibits and other material made equally vigorous demands upon the time and energies of the staff and the Commission in their respective consideration of the many complex issues in this case.[11/] Thus, much of the delay which occurred in these proceedings arose from three sources, none of which can be laid at the door of the Commission: (1) petitioners' dilatory and delaying actions, (2) similar moves by other respondents in the consolidated proceedings and (3) the enormity of the record and the proceedings.

Petitioners' reliance on Section 9(a) of the A.P.A., 5 U.S.C. 1008(a), (Br. 22) is wholly misplaced. Neither the language nor legislative history of that section provides any suggestion that

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11/ The statistical comparison made by petitioners in their brief (Br. 21) is incomplete and misleading. It is true that these proceedings consumed more time than usual for such proceedings. However, because the hearing and the record of the proceedings were so many times greater than normal, the length of time which elapsed until the preliminary decision and from the preliminary to final decision was not disproportionate. Much of the delay between oral argument and final decision by the Commission was attributable not only to the sheer size of the record, but also an increase in the Commission's case load, the intensive effort on the part of the Commission which was required during a substantial portion of this period in completing and reviewing the massive Report of the Special Study of the Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963), that was initiated late in 1961 and transmitted to the Congress during the summer of 1963, and finally, the unfortunate illness and resignation of Commissioner Frear which left the Commission without a quorum available for the consideration of this case from September 1963 until late March 1964.

Congress intended to take away statutory powers it had specifically granted to a regulatory agency to impose sanctions upon persons regulated who were found to have violated the law. In any event petitioners' argument is completely irrelevant in the situation here, where much of the delay is attributable to petitioners' own actions.

III. PETITIONERS HAVING AGREED TO THE PARTICIPATION BY ANY COMMISSIONER AT THE TIME OF DECISION WHO IF HE HAD NOT HEARD ORAL ARGUMENT WOULD READ THE TRANSCRIPT, A LEGALLY CONSTITUTED QUORUM OF THE COMMISSION DECIDED THIS CASE.

Oral argument in this matter was heard before the Commission composed of Chairman Cary, and Commissioners Whitney and Cohen. Commissioner Woodside had disqualified himself and Commissioner Frear was absent (Doc. No. 1099, p. 1-2). The Commission's opinion was issued by Commissioner Whitney, joined by Chairman Cary and by Commissioner Owens who took office subsequent to the oral argument. Commissioners Woodside and Cohen did not participate. 11a/ Since it had been agreed by the parties that any Commissioner at the time a decision was rendered might participate in the decision with the understanding that if he had not been present at oral argument he would read the transcript of the argument Commissioner Owens' participation was proper and a valid quorum of the Commission rendered the decision herein. 12/

Oral argument before an administrative agency is not required by the A.P.A. nor by the statutes which the Commission administers. Moreover, due process of law does not require that an opportunity for

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11a/ Commissioner Cohen's decision not to participate, apparently based on an abundance of precaution because of his prior position on the staff, came after oral argument.

12/ Three members of the Commission constitute a quorum. International Paper and Power Co. 2 S.E.C. 792 (1937), rev'd. on other grounds, sub. nom., Lawless v. Securities and Exchange Commission, 105 F. 2d 574 (C.A. 1, 1939); See Otis & Co., 31 S.E.C. 380 (1950).

oral argument be granted.[13] Nevertheless, Rule 21(a) of the Commission's Rules of Practice, 17 CFR 201.21(a), provides in pertinent part that,

> upon written request of any party a matter will be set down for oral argument before the Commission unless exceptional circumstances make oral argument impractical or inadvisable.[14]

The Commission's practice with respect to oral argument was recently described as follows:

> Under this rule and its predecessors, it has been our general practice to accord oral argument before us upon request on substantive matters but not to grant it on procedural matters or on motions and petitions.
>
> For some years now it has been this Commission's practice for the Chairman or presiding Commissioner to state at the opening of every oral argument that "it is proposed that any Commissioner at the time a decision is rendered in this case may participate therein with the understanding that if he was not present at this oral argument he will read the transcript of the argument," and to ask whether this procedure is agreeable to all counsel. This practice, which has been uniformly followed, even when all members of the Commission then serving were present

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13/ McGraw Electric Co. v. United States, 120 F. Supp. 354 (E.D. Mo. 1954) aff'd. 348 U.S. 804; F.C.C. v. W.J.R., 337 U.S. 265 (1949). Indeed, the Supreme Court in its practice denies oral argument in certain cases. See, 1 Davis, Administrative Law § 7.07.

14/ Recent changes in the Commission's Rules of Practice pointed out in petitioners' brief (Br. 24, fn. 2) are not here pertinent since they went into effect after this case was decided.

> at a particular oral argument, is intended to remove any possible doubt as to the right to participate in the decision not only of any existing but absent member of the Commission, but also of any new Commissioner becoming such after the oral argument and before decision of the matter. And it has been normal practice for Commissioners becoming such after oral arguments in various cases to participate in the decisions in those cases, following their reading of the transcript of the oral argument, which is recorded by an official stenographer. [Isthmus Steamship & Salvage Co., Inc.; Robert Edelstein Co., Inc. Securities Act Release No. 4743, Securities Exchange Act Release No. 7476 (December 21, 1964) reported in C.C.H. Federal Securities Law Reporter ¶ 77,166, 82,220, at 82,211].

The described practice was followed in these proceedings. The following is the complete colloquy between the Commission and counsel for the parties which preceded the oral argument:

> CHAIRMAN CARY: * * * * *
>
> It is proposed that any Commissioner at the time a decision is rendered in this case who has not disqualified himself may participate therein, with the understanding that if he was not present at this oral argument he will read the transcript of the argument.
>
> Is this agreeable to all counsel?
>
> MR. KIERNAN: It is agreeable to McCoy and Willard.
>
> MISS ANTELL: Yes.
>
> MR. PALMER [Counsel for Petitioners]: I beg your Honor's pardon. Ordinarily, would that mean there would be four Commissioners sitting?

CHAIRMAN CARY: That would mean in this particular case that, assuming that all of us are still living, it would be decided by four Commissioners apart from Commissioner Woodside, who has disqualified himself.

MR. PALMER: You will forgive me because this is the second time in my life, and it has been a long life, that I have appeared before the Commissioners, I have seen them as individuals. Would that mean, then, that Commissioner Woodside would then read this record before making the decision?

CHAIRMAN CARY: It does not mean that. He has disqualified himself from deciding this case or participating in it.

MR. PALMER: And the other Commissioner --

CHAIRMAN CARY: Commissioner Frear, having read the record, will participate in the decision.

MR. PALMER: Having read the record?

CHAIRMAN CARY: Having read the record.

MR. PALMER: Your Honor understands only part of the record is in the room.

CHAIRMAN CARY: I will not say he will have read every page of it, but I merely mean that he will have satisfied himself, put it that way.

MR. PALMER: Will you forgine (sic) me, then, for asking these questions?

CHAIRMAN CARY: Proceed.

MR. PALMER: I have nothing to proceed, you have told me.

CHAIRMAN CARY: What is your conclusion?

MR. PALMER: My conclusion is to do what you have asked before. I am satisfied to have the absent Commissioner read the record and see the exhibits and then join in with the others.

CHAIRMAN CARY: I will not guarantee for him that he will read every page in that record. Perhaps I should now repeat my previous statement. It is proposed that any Commissioner at the time a decision is rendered in this case who has not disqualified himself may participate therein, with the understanding that if he was not present at this oral argument he will read the transcript of the argument. I do not say that he will read all of the record.

MR. PALMER: The transcript of the argument?

CHAIRMAN CARY: Yes.

MR. PALMER: Heaven help you gentlemen if you had to read the transcript of the record; the argument might be bad enough.

CHAIRMAN CARY: I agree with you. I will not speak for the argument [sic, record]; obviously, that remains to be seen.

MR. PALMER: When I find the Commission agrees with me, I had best sit down.

CHAIRMAN CARY: Upon your sitting down, may we assume that the Commissioner who is not present may participate in the case?

MR. PALMER: Yes, your Honor.

CHAIRMAN CARY: That is all we want to know. [Doc. No. 1099, pp. 2-5].

It is clear from the foregoing that the petitioners' consent to the participation "at the time a decision is rendered" by a Commissioner who was not present at oral argument was not limited only to the absent Commissioner Frear as they suggest. The Chairman assumed in making reference to Commissioner Frear at some points in the colloquy that Commissioner Frear would be in office at the time of a decision because his term did not expire until June 1965.[15/] That does not mean that the scope of the understanding was limited solely to his participation.

15/ 28th Annual Report Securities and Exchange Commission, xiv (1962).

Obviously Chairman Cary would not have referred to "any Commissioner" unless he was contemplating the possibility of future commissioners participating in the decision, since Commissioner Frear was the only Commissioner at that time absent from the oral argument who had not disqualified himself. This is emphasized by Chairman Cary's reference to "any Commissioner at the time the decision is rendered in this case who has not disqualified himself" in stating who might participate, instead of reference to Commissioner Frear to whom he had already specifically referred. Moreover, Chairman Cary made clear the possibility of future commissioners sitting at the time of oral argument by his qualification "assuming that all of us are still living."

The Commission recently considered the matter of the participation of an absent Commissioner in denying rehearing in Isthmus Steamship and Salvage Co., Inc.; Robert Edelstein Co., Inc., supra, C.C.H. Federal Securities Law Reporter at 82, 222, where the following took place:

> Later in the oral argument Estreicher's then attorney, Mr. Sablosky, entered the hearing room. He was asked by Chairman Cary whether he chose to make the same waiver as to participation by Commissioner Cohen as Mr. Feldman and Mr. Sinkman, and he stated that he did. The discussion then continued as follows:
>
> > "Commissioner Whitney: Mr. Chairman, perhaps this counsel should also state whether he agrees as to Senator Frear who is not here. He may also participate.
> >
> > "Chairman Cary: I think that is correct. I appreciate the suggestion.

> "At the time I read the normal statement that we make the beginning of an argument, that any Commissioner at the time a decision is rendered in this case may participate therein, which would be the other Commissioner we have referred to, Commissioner Cohen who is not present, the other Commissioner being Commissioner Frear, it was agreed that he may participate with the understanding that if he was not present at this oral argument he would read the transcript of the argument. Do you have any objection to that?
>
> "Mr. Sablosky: No objection."

In response to the contention that the foregoing precluded participation in the decision by any one not then a Commissioner, the Commission concluded:

> However, we think that such a sweeping inference drawn from those remarks is untenable, particularly when viewed in the light of the Chairman's earlier statement. It was not significant under the circumstances that the Chairman referred specifically only to the then members of the Commission who were absent. The reference in general terms to "any Commissioner at the time a decision is rendered in this case" was intended to be and was clearly applicable as well to future members. Moreover, no valid reason appears why a distinction should be made between absent future members and absent present members, particularly here where Commissioner Owens' participation was in accordance with our usual practice and the procedure contemplated by the statements at the oral argument: he read the transcript of the oral argument, studied the briefs, and otherwise familiarized himself with the case prior to the issuance of the decision. We therefore reject petitioners' contention that he was not entitled to participate. Moreover he was joined in a unanimous decision by two members of the Commission who had heard the oral argument. Under all the circumstances we conclude that petitioners are not entitled to a rehearing because of Commissioner Owens' participation. (footnotes omitted).

That case seems indistinguishable from these proceedings and the Commission's conclusions are equally applicable here.[16/]

If petitioners' narrow approach to the scope of their agreement were to be accepted, it would mean that any change in the identity of the members of the Commission after oral argument would present insurmountable obstacles to the efficient operation of the administrative decisional process. Between the time when Commissioner Woodside succeeded Commissioner Orrick in July of 1960 and the present time fourteen persons have served as members of this five-man Commission. In view of this rate of turnover it is awesome to contemplate how many of the Commission's administrative cases would have to be re-argued if participation in its decisions were limited to members present at oral argument or even to members who were such at that time though absent from the argument.[17/] No such impediment to the functioning of the Commission as a continuing body was envisaged in the statute creating it; nor does securing due

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16/ The denial of re-argument in the Isthmus case is of course no answer to our basic position that petitioners should have moved for re-argument in this case as a prerequisite to raising that issue in court. On such a motion factors might well have been brought out as to this case which were not present in Isthmus.

17/ If either of the petitioners' conclusions (that the case should be dismissed or should be completely retried upon a new record, not just re-argued orally before the present members of the Commission) were to prevail it would lead to even greater havoc in the process of disposing of administrative cases.

process of law to respondents in Commission proceedings compel any such result.[18] Numerous decions by the courts and the administrative agencies[19] clearly establish that a member of an administrative agency who did not hear oral argument may nevertheless participate in the decision where he has the benefit of the record before him.[20] Where the parties agree to the participation of a Commissioner at the time a decision is rendered who was absent from oral argument subject to his reading the transcript of the argument, that conclusion is even more persuasive.

18/ United Air Lines v. Civil Aeronautics Board, 108 App. D. C. 220, 281 F. 2d 53 (1960); Sisto v. Civil Aeronautics Board, 86 App. D. C. 31, 179 F. 2d 47 (1949); Twin City Milk Producers Ass'n. v. McNutt, 122 F. 2d 564 (C.A. 8, 1941); Eastland v. Federal Communications Commission, 67 App. D.C. 316, 92 F. 2d 467 (1937) cert. den. No.302 U.S. 735; United States v. Reimer, 83 F. 2d 166 (C.A. 2, 1936); McGraw Electric Co. v. United States, 120 F. Supp. 354 (E.D. Mo. 1954) aff'd. 348 U.S. 504 ; United States v. Seminole Nation, 173 F. Supp. 784(Ct. Cl. 1949); Visceglia v. United States, 14 F. Supp. 355 (S.D. N.Y. 1938).

19/ Southeastern Area Local Service Investigation, 10 Pike & Fisher Administrative Law 2d (Ad. L. 2d) 353 (C.A.B. 1960); Triad Television Corp., 27 F.C.C. 96, 9 Ad. L. 2d 617 (1959); Power Authority of State of New York, 21 F.P.C. 273, 9 Ad. L. 2d 169 (1959); Indianapolis Broadcasting, Inc., 23 F.C.C. 579, 7 Ad. L. 2d 601 (1959); Amendment of Section 3.606, 5 Ad. L. 2d 646 (F.C.C. 1955).

20/ This is in accord with the practice apparently followed by this Court. Thus at oral argument in Securities and Exchange Commission v. R. A. Holman & Co., 116 App. D.C. 279, 323 F. 2d 284 (1963), Chief Judge Bazelon advised counsel (without asking for their consent) that a record of the oral argument would be made available to Judge Bastian who was not present but would participate in the decision.

The only case which lends any colorable support to petitioners' position, W.I.B.C. v. Federal Communications Commission, 104 App. D. C. 126, 259 F. 2d 941 (1958) cert. den. 358 U.S. 920, is clearly distinguishable because of the narrow waiver by the parties to that case and and because the Communications Act,[21/] unlike the Exchange Act, requires oral argument. In the W.I.B.C. case this Court vacated certain orders of the Federal Communications Commission (F.C.C.) and instructed the F.C.C. to set the case for a second oral argument because Commissioner Craven, whose vote was decisive became a member of the F.C.C. after the original oral argument[22/] and "such argument having been requested and not clearly waived." Rehearing was denied by the Court en banc in an opinion which explained what was meant by the statement in its original opinion that oral argument had not been "clearly waived."

> It was said that his participation in oral argument had been waived; and the basis for saying so was the announcement that any absent Commissioner might take part, to which there was no objection. But Craven was not an "absent Commissioner" - he was not a Commissioner at all. [Emphasis added] 104 App. D. C. at 127, 259 F. 2d at 942.

21/ Section 409(b), 47 U.S.C. 409(b).

22/ Thus this Court did no more than what we have suggested the Commission might have done if a request for reargument had been addressed to it by a post-decision application (supra p. 12 of this brief).

In the present case participation was waived as to "any Commissioner at the time a decision was rendered, who might participate if he was absent from oral argument by reading the transcript of the argument; the waiver was not confined only to an "absent Commissioner" as in the W.I.B.C. case. The other cases cited by petitioners in support of their position are inapposite.

From the foregoing it is clear that a validly constituted quorum of the Commission decided this case.

IV. THE COMMISSION CORRECTLY HELD THAT INTENTIONAL ACTS IN VIOLATION OF THE SECURITIES LAWS WERE "WILLFUL" UNDER SECTION 15(b) OF THE EXCHANGE ACT AND THAT CERTAIN VIOLATIONS OF SECTION 15(c)(1) OF THE EXCHANGE ACT WERE AIDED AND ABETTED BY THE INDIVIDUAL RESPONDENTS.

Section 15(b) of the Exchange Act provides, inter alia, that the Commission shall by order, after notice and opportunity for hearing, revoke the registration of a broker-dealer if it finds such revocation in the public interest and that such broker-dealer or any partner, officer or director thereof has willfully violated any provision of the Securities Act or the Exchange Act or any of the rules under either of those statutes. The term "willfully" is not defined by the Exchange Act. Nevertheless, it has been consistently interpreted by the Commission to mean that if a respondent acts intentionally, in the sense that he knows what he is doing, his action is willful and that there need be no intention to violate the law. That interpretation has been consistently approved by this Court. In Hughes v. Securities and Exchange Commission, 85 App. D.C. 56, 64, 174 F. 2d 969, 977 (1946), this Court held that for purposes of Section 15(b)(D) willfulness means "no more than that the person charged with the duty knows what he is doing. It does not mean that in addition, he must suppose that he is breaking the law." See also Shuck v. Securities and Exchange Commission, 105 App. D.C. 72, 264 F. 2d 358 (1958); Norris & Hershberg, Inc. v. Securities and Exchange Commission, 85 App. D.C. 268, 177 F. 2d 228 (1949).

In its Findings and Opinion the Commission made detailed specific findings together with reasons therefor with respect to each separate violation charged, showing that such violations by petitioners had been "willful" (Doc. No. 1079, pp. 8-11, 20-21, 23-24, 27-29, 29-31, 33-34). In addition, in response to petitioners' urging below that the Commission reconsider its interpretation of "willfulness," with respect to violations of Section 5 of the Securities Act, 15 U.S.C. 77e, the Commission in its Findings and Opinion carefully rearticulated the above described standard of "willfulness" and the basis therefor, including the well recognized decisions of this Court (Doc. No. 1079, pp. 8-9).

The discussion of willfulness to which petitioners take particular exception (Br. 29) referred in context only to the alleged violation of the registration requirements of the Securities Act discussed at that point in the Commission's opinion. Where violations of the fraud provisions were involved, the Commission was at pains to demonstrate that petitioners actually knew, or were at least on notice, of the false and misleading character of the statements in question. Violation of the registration requirements of the Securities Act presents special questions in regard to willfulness. Section 5 of the Securities Act makes unlawful the sale of securities by instrumentalities of federal jurisdiction unless a registration statement is in effect. Thus, a violation of this section can be shown simply by

proof that securities were sold by means of these instrumentalities and that no registration statment had ever been filed. If a dealer knowingly sells securities and knows that there is no registration statement in effect he can be said to have "willfully" violated Section 5, without the Commission further proving that he knew that no exemption from registration was available. Indeed, this has been held even in a criminal case. Edwards v. United States, 312 U.S. 473, 483 (1941) ~~[reversed on other grounds]~~; United States v. Sussman, 37 F. Supp. 294, 296 (E. D. Pa., 1941). One who sells securities which are unregistered has the burden of coming forward with proof to the effect that an exemption is available. Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119 (1953); Gilligan, Will & Co., v. Securities and Exchange Commission, 267 F. 2d 461 (C.A. 2, 1959), cert. den., 361 U.S. 896; Securities and Exchange Commission v. Culpepper, 270 F. 2d 241 (C.A. 2, 1959). Consequently, the Commission is not required to prove that no exemption was available and still less that the dealer knew this.

Although it would appear that the standard of willful conduct as enunicated by the Commission would be clear beyond question, petitioners nevertheless assert that they "do not know what the proposition means that a finding of willfulness does not require a finding of an intent to violate and that there need only be an intent to do the act which constitutes the violation." (Br. 32.) They then

suggest, in a maze of confusion and intemperate remarks, that in view of the standard of "willfulness" the Commission's decision in this matter either lacked findings, as required by Section 8(b) of the A.P.A., 5 U.S.C. 1007(b), or that such findings were not supported by substantial evidence. Petitioners, however, have not specified these alleged deficiencies in the Commission's Findings and Opinion. The only uncertainty with respect to the standard of "willfulness" as approved by this Court rests with petitioners. Even a cursory reading of the Commission's opinion discloses careful, detailed findings and reasons concerning "willful" violations. Further, petitioners do not deny, as found by the Commission that the violations were "willful" as that term has been defined by the Commission and this Court. Their quarrel is rather with those well established definitions.

The petitioners' assertion that the Commission also failed to make findings with respect to the conclusion that the individual petitioners "aided and abetted" certain violations by Gearhart & Otis, Inc., is likewise without support. The use of the terms "aided and abetted" was confined to the violations by petitioners of Section 15(c)(1) of the Exchange Act, 15 U.S.C. 78o(c)(1), which by its terms can be directly violated only by a registered broker-dealer.[23/] The

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23/ That Section provides: "No broker or dealer" shall make use of interstate facilities to effect any transaction in securities otherwise than on a national securities exchange, by means of any manipulative, deceptive, or other fraudulent device or contrivance. (Emphasis added.) The other antifraud provisions of the securities laws have reference to "any person" engaging in such conduct. (Section 17(a) of the Securities Act; Section 10(b) of the Exchange Act.)

Commission has long held that participation by a person associated with a broker-dealer in conduct prohibited by that Section constitutes aiding and abetting such violation of the broker-dealer. See, e.g., Luckhurst & Co., Inc. 40 S.E.C. 539 (1961); Mason, Moran & Co., 35 S.E.C. 85 (1953); William Todd, Inc., 32 S.E.C. 537 (1951); Henry P. Rosenfeld, 30 S.E.C. 941, 944, fn. 3(1950); Burley & Co., 23 S.E.C. 461, 468, fn. 11 (1946). Moreover, this practice has received the tacit approval of this and other courts. See Batten & Co. v. Securities and Exchange Commission, App. D.C. , F. 2d (1964), unreported, see C.C.H. Federal Securities Law Reporter '61-'64 Decisions, ¶ 91,356; Barnett, et al. v. Securities and Exchange Commission, 319 F. 2d 340 (C.A. 8, 1963).[24] Conduct of the two individuals on behalf of their two-man corporation found to be a violation of the Exchange Act by the corporation can certainly provide a basis for finding such individual responsibility as well. Recognizing the efficacy of this practice, Congress codified it by the Securities Act Amendments of 1964, P.L. 88-467.[25] Subparagraph (E) of Section 15(b)(5) now provides that aiding and abetting in a

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24/ The Commission's aider and abettor theory has also been applied by the courts as a basis for injunction. Securities and Exchange Commission v. Scott Taylor & Co., Inc., 183 F. Supp. 904, 909, fn. 12 (S.D. N.Y., 1959); Securities and Exchange Commission v. Timetrust, Inc., 28 F. Supp. 34, 43 (N.D. Cal., 1939).

25/ See S. Rep. No. 379, 88th Cong., 1st Sess. 76 (1963).

violation by another person is an additional basis for disciplinary action by the Commission under its new procedures. Such findings by the Commission in this case, however, merely followed recognized, accepted practice and did not involve any application of the new statute to a set of facts which preceded it.

V. IN PROCEEDINGS FOR REVOCATION OF THE REGISTRATION OF A BROKER-DEALER PURSUANT TO SECTION 15(b) OF THE EXCHANGE ACT, THE COMMISSION MAY FIND AS A BASIS FOR REVOCATION THAT A PRINCIPAL OF SUCH BROKER-DEALER WILLFULLY VIOLATED SECTION 7 OF THE SECURITIES ACT.

The Commission found that Gearhart willfully violated Section 7 of the Securities Act, 15 U.S.C. 77g, incident to his participation in the preparation of or supplying information for the registration statement of National Lithium Corporation, which contained materially misleading statements and omitted required information. The

registration statement had earlier been subject to stop order proceedings, 40 S.E.C. 746 (1961), and by stipulation [26] the record of those proceedings was made part of the record of the proceedings herein under review (Doc. No. 1079, p. 26, fn. 37). As to matters within his special knowledge, the Commission found that Gearhart was to be accountable under Section 7 of the Securities Act for misleading statements and omissions in the registration statement.

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[26] The assertion in petitioners' brief that the record in the stop order proceeding was incorporated in the record of these proceedings over the objection of petitioners (Br. 36) is not accurate. The stipulation as to the stop order record was considered by the Commission in its opinion:

> G&O responsents now urge that they entered into the stipulation on the basis of the Division's assurance that they would have an opportunity to cross-examine witnesses who had testified in the stop order proceedings, and that they withdrew from the stipulation when it appeared they would not be able to cross-examine certain of such witnesses who were beyond our territorial jurisdiction. They contend that under these circumstances, no reliance may be placed on the stop order record. While counsel for these respondents stated at one point during the hearings that he was withdrawing his stipulation unless the Division sent letters to certain Canadians who had testified in the stop order proceedings, urging them to make themselves available for examination by respondents, he expressed his satisfaction with letters to that effect thereafter written by the hearing examiner. The entire hearing on the National Lithium issues proceeded on the basis that the stop order record was part of the instant record. Under these circumstances, respondents cannot complain of a procedure to which they expressly agreed. We also note that G&O participated in the stop order hearings and had an opportunity to cross-examine the Canadian witnesses with respect to the issues involved in those hearings, while Gearhart as well as G&O participated in the post-hearing procedures in the stop order proceedings. (Emphasis added.) (Doc. No. 1079, p. 26, fn. 37.)

Petitioners' assertions that Section 7 of the Securities Act "by its terms and purport, cannot be violated as a matter of law," (Br. 37.) and that there was no basis for the Commission's finding of such violation in these proceedings, are erroneous. Implicit in the requirement of Section 7 that a registration statement contain certain information is the requirement that such information be true and correct.[27/] As petitioners acknowledge, criminal penalties are prescribed for willfully making untrue or misleading statements in a registration statement.[28/] Surely administrative sanctions can be imposed for the same conduct. Although Section 7 of the Securities Act does not specifically provide that it is unlawful to file false or misleading registration statements, it is clear that the filing of a registration statement containing false and misleading material is not a registration statement containing the information specified in the Securities Act and the rules thereunder. The signing of a registration statement known to be false and misleading has been consistently held to be a willful violation of that Section. E.g., Securities and Exchange Commission v. Universal Service Corporation, unreported, No. 11608 (So. D. Tex., 1958); Eugene M. Rossenson, et al., 40 S.E.C. 948, 952 (1961). Petitioners conveniently ignore the clear and express

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27/ See Eugene M. Rossenson, et al., 40 S.E.C. 948, 952 (1961).

28/ Section 24 of the Securities Act, 15 U.S.C. 78x.

language of Section 15(b) of the Exchange Act which provides that:

> The Commission shall, after appropriate notice and opportunity for hearing, by order . . . revoke the registration of, any broker or dealer if it finds that such . . . revocation is in the public interest and that . . . any . . . officer [or] director . . . of such broker or dealer . . . whether prior or subsequent to becoming such, . . . has willfully violated any provision of the Securities Act of 1933 . . . or of any rule or regulation thereunder. (Emphasis added.) 29/

It is clear that where a registration statement is signed by one who is an officer and director of a registered broker-dealer who knew or should have known that it contained false and misleading material, such willful violation of Section 7 of the Securities Act is a basis for revocation of the registration of the broker-dealer by reason of the express provisions of Section 15(b). In addition, the Commission was careful to make new and separate findings with respect to Gearhart's violation of Section 7 of the Securities Act (Doc. No. 1079, pp. 26-29). 30/

29/ In view of the terms of Section 15(b) there would appear to be no question of "jurisdiction" of the Commission as petitioners assert (Br. 37).

30/ The mere fact that the Commission had concluded in the earlier stop order proceeding that the registration statement contained false and misleading material does not show prejudgment or bias in this case. As the Supreme Court stated in Federal Trade Commission v. Cement Institute, 333 U.S. 683, 763 (1948):

> [J]udges frequently try the same case more than once and decide identical issues each time, although these issues involve questions both of law and fact. Certainly the Federal Trade Commission cannot possibly be under stronger constitutional compulsion in this respect than a court. (Footnote omitted.)

CONCLUSION

For the foregoing reasons, the petition for review should be dismissed to the extent that it raises objections not urged before the Commission, and the order of the Commission herein under review should be affirmed. 31/

Respectfully submitted,

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Securities and Exchange Commission
Washington, D. C. 20549

March 1965

31/ In view of the fact that none of the objections asserted by petitioners compels reversal of the Commission's order, there is no need to consider any possible cumulative effect of any "errors" described in petitioners' brief (Br. 37-38). Similarly, the disconnected collection of authorities contained in petitioners' brief (Br. 38) concerning a variety of matters seemingly drawn at random does not appear to warrant comment by respondent other than to point out that Commission proceedings are not penal in nature, but are remedial, serving as a means to protect the public interest. Blaise D'Antoni & Associates, Inc. v. Securities and Exchange Commission, 289 F. 2d 276, 277 (C.A. 5, 1961), rehearing denied, 290 F. 2d 688; Pierce v. Securities and Exchange Commission, 239 F. 2d 160, 163 (C.A. 9, 1956). Moreover, the concern shown by petitioners in their brief (Br. 39) for the well-being of brokers and dealers who are regulated by the Commission offers no reason for petitioners to escape responsibility for proven violations of the federal securities laws.

REPLY BRIEF FOR PETITIONERS

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18, 817

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR. AND EDWARD V. OTIS,

Petitioners,

V.

SECURITIES AND EXCHANGE COMMISSION AND UNITED STATES OF AMERICA,

Respondents,

Petition for Review of An Order
of Securities and Exchange
Commission

March 27, 1965

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UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18,817

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR., and EDWARD V. OTIS,

Petitioners

v.

SECURITIES AND EXCHANGE COMMISSION and UNITED STATES OF AMERICA,

Respondents.

PETITION FOR REVIEW OF AN ORDER OF THE SECURITIES AND EXCHANGE COMMISSION

PETITIONERS' REPLY BRIEF

Respondent in its Brief plays down the importance of the issues raised in this appeal. In Respondent's view, procedural due process is a matter within the uninhibited exercise of so-called agency "expertise" and is overridden by the alleged requirements of administrative necessity. Such a view vitally and adversely affects not only the rights of the Petitioners herein but also those of the thousands of organizations and individuals regulated by the Securities and Exchange Commission. The law is, of course,-- and this Court has the duty

to hold -- otherwise.

I. PETITIONERS' FAILURE TO FILE A PETITION FOR REHEARING WITHIN FIVE DAYS AFTER THE AGENCY DECISION BELOW DOES NOT PRECLUDE THEM FROM OBJECTING THAT THE COMMISSION FAILED TO PROCEED WITH "REASONABLE DISPATCH" AND THAT AN INVALIDLY CONSTITUTED QUORUM OF THE COMMISSION DECIDED THE CASE.

Respondent states that, under the doctrine of exhaustion of administrative remedies and the requirements of Section 25 [1/] of the Securities Exchange Act, and Section 9 of the Securities Act, [2/] Petitioners may not challenge before this Court either the failure of the Commission to proceed with reasonable dispatch or the agency decision by an invalidly constituted quorum (Brief, pp. 8-12). The argument is without merit.

Under the procedure in effect prior to August 1, 1964, all that the examiner issued was a recommended decision. Therefore, the agency decision was the initial decision first raising the issues of reasonable dispatch and lack of a valid quorum. A petition for rehearing on these issues was permitted to be filed within five days after this initial decision, SEC Rules of Practice, Rule 21(a). [3/]

Under the facts of this case, five days is not a reasonable time. Indeed, it is per se unreasonable to require a party to comply with such a time schedule.

1/ 15 U.S.C. §78y. For text, see Petitioners' Brief, pp. 9-10.
2/ 15 U.S.C. §77i. For text, see Petitioners' Brief, p. 7.
3/ 17 C.F.R. §201.21(e): "Any petition for rehearing by the Commission shall be filed within 5 days after entry of the order complained of and shall clearly state the specific grounds and the specific matters upon which rehearing is sought."

Counsel[4] for Petitioners would have had less than a week to review a 39-page decision, complete the necessary factual and legal research to sustain his arguments concerning reasonable dispatch and lack of a quorum, and formulate, "clearly state," and file "the specific grounds and the specific matters upon which rehearing is sought."

Respondent's claim that "Petitioners could have urged the Commission's asserted failure to proceed with 'reasonable dispatch' . . . at any stage of the proceedings when they believed the Commission to have been proceeding too slowly" (Respondent's Brief, p. 11). At least one of the Petitioners did so complain of the Commission's failure to reach a decision by March and April 1963. "[W]riting without the aid of an attorney to save money", he stated:[5]

> "I have been virtually 'out of business' for some six or seven years due to the pending proceedings and my desire to avoid any possible aggravation of the situation. About two years or more have passed since the hearings were concluded. My financial situation has gone down from a multi-millionaire to a point where I can't pay my bills, had to go out of business and could not get new capital because of the unresolved proceedings. I also owe a considerable income tax as a result of assessments from the good years of 1954 and 1955."

Petitioners are entitled to substantial -- not literal -- due process.

Rule 21(e) may be fair with respect to some parties appearing before the SEC.

As applied to Petitioners, however, the rule is inequitable and unreasonable.

4/ This lack of reasonable time was further complicated by the fact that present Counsel did not become involved in the case until on or about July 1, 1964, the time for filing a petition for review having expired on June 7, 1964. After June 2, 1964, and until on or about July 1, 1964, Petitioners were without effective representation in this matter.

5/ Exhibits A, B, and C attached hereto. These letters are from the SEC's correspondence file in File No. 8-2729. Further, in the course of discussing possible avenues of agreement in accordance with law after July 1, 1964, during the pendency of this appeal, present counsel for Petitioners did present to counsel for the Commission the reasons and questions raised by this Brief with a view to settlement.

II. THE COMMISSION DID NOT ACT WITH "REASONABLE DISPATCH" AND THEREBY IMPOSED AN UNAUTHORIZED SANCTION.

Respondent does not challenge the statistics[6/] presented by Petitioners. It even concedes that "these proceedings consumed more time than usual for such proceedings", and that the Commission was "without a quorum from September 1963 until late March 1964."[7/]

The requirements of "reasonable dispatch" under Section 6(a) of the Administrative Procedure Act, 5 U.S.C. §1005(a), apply to both adjudications and investigations, Sen. Doc. No. 248, 79th Cong., 2d Sess. 353-354 (1947) ("Section 6 deals with . . . investigative powers"); see United States v. Batten, 226 F. Supp. 492, 494 (D.D.C. 1964). The Commission spent ten years investigating and prosecuting Petitioners, all as part of a continuous and consolidated proceeding. Ten years is per se unreasonable and a denial of due process. Section 6(a) of the statute was clearly violated.

Petitioners concede that a small fraction of this ten-year period was used by Petitioners in resorting to remedies guaranteed by law. Respondents appear

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6/ Petitioners' Brief, p. 21.

7/ Respondent's Brief, p. 19. The matters sought to be alleged to justify the Commission's excessive delay in deciding this case are immaterial and, if true, an interesting apology for the administrative process. The Commission did not prepare or write the Report of the Special Study of the Securities Markets; "***The examination of the securities markets and the writing of the report have been done by a separate group established in the Commission and designated the Special Study of Securities Markets....***", H.R. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess. iv (1963). The Commission does not even prepare its own decisions. These are prepared by the Office of Opinions and Review, formerly the Office of Opinion Writing, see Survey and Study of Administrative Organization, Procedure and Practice in the Federal Agencies, Part 11D, 85th Cong. 1st Sess. 1957 (Comm. Print 1957); 17 C.F.R. §30-6 (1964).

to claim that such resort automatically removes the agency's statutory duty to proceed with reasonable dispatch. Indeed, wearing "all of the hats involved in the proceedings instituted under its authority" and "at once, the accuser, prosecutor, the judge, and the jury", Respondent controls the course of the proceedings. Niresk Industries v. F.T.C., 278 F.2d 337, 340-341 (7th Cir. 1960), cert. denied, 364 U.S. 883.

For example, the Commission's hearing examiner did not issue his recommended decision until July 26, 1961, thirty months after the closing of the record (Certified Transcript, Docs. Nos. 1028-1036, 1044).[8/] This compares with an average of 3.3 months for similar Commission proceedings (Petitioners' Brief, p. 21).

Further, had the decision of the Commission been prepared by its Office of Opinion Writing before the departure of Commissioner Frear in September 1963, when the agency rendered itself powerless to reach a decision, the delay until June 1964 would never have occurred.

The Commission did not act with reasonable dispatch to investigate and adjudicate the issues in the proceedings below. Section 6(a) of the Administrative Procedure Act is not merely an exhortation, an empty gesture. Rather, the statute imposes an affirmative duty upon the administrative agency. Failure to comply with this duty is a violation of statute and due process of law, regardless of the agency's professed good intentions. The statute recognizes that delay is, in effect, a sanction. Imposition of this

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8/ Unless the Court should otherwise require, the parties, wherever possible, are using items set forth in the Certified Transcript concerning which there is no factual question, see, e.g., Respondent's Brief, pp. 16-18.

sanction contravenes Section 9(a) of the Administrative Procedure Act, 5 U.S.C. §1008(a).

As one Petitioner noted to the Commission, he and Registrant had been virtually out of business since the commencement of the proceedings (Exh. A). Excessive -- "unreasonable" -- delay did penalize Petitioners and cause them irreparable injury.[9/]

III. PETITIONERS DID NOT AGREE TO THE PARTICIPATION IN THE DECISION BY ANY COMMISSIONER NOT PRESENT AT ORAL ARGUMENT.

Petitioners did not agree that "any Commissioner at the time a decision was rendered might participate in the decision with the understanding that, if he had not been present at oral argument he would read the transcript of the argument" (Respondent's Brief, p. 21). All that then counsel for Petitioners agreed to was to "have the absent Commissioner" -- shortly theretofore and clearly identified as Commissioner Frear -- "read the record and see the exhibits and then join in with the others" (Jt. App. 42-43). The "others" were Commissioners Cary, Cohen, and Whitney (Ibid. 40). The fact is that a quorum of these four agency members -- that is, at least three -- did not participate in the decision.

9/ The balance sheet of Registrant, as of October 31, 1955, showed total assets of about $580,000 and equivalent liabilities which included a capital surplus of about $122,000 (Certified Transcript, Doc. No. 832). As of December 31, 1961, Registrant had a total ledger debit balance of about $678,000, including a deficit of about $313,000 (Doc. No. 842). By letter dated February 13, 1964, Registrant informed the Commission that "[W]e have no regular employees and we are doing no business whatsoever nor do we intend doing any" (Doc. No. 843).

Petitioners' approach to this problem is neither "narrow" nor calamitous to the functioning of the SEC's decisional process (Respondent's Brief, pp. 28-29). The "rule of necessity" applies only where the non-use of a biased agency or Court member produces an entire failure of justice. Marquette Cement Mfg. Co. v. Federal Trade Commission, 147 F.2d 589, 593 (7th Cir. 1945), rev'd on other grounds sub nom., Federal Trade Commission v. Cement Institute, 333 U.S. 683, 700-703; State v. Aldridge, 212 Ala. 660, 103 So. 835, 838 (1925); Stahl v. Board of Supervisors, 187 Iowa 1342, 175 N.W. 772, 776 (1920). Through its own inaction, Respondent was unable to muster a duly qualified quorum between September 1963 and March 1964. When the new Commissioner joined the agency, the case could have been rescheduled for oral argument, assuming that the Commission had not otherwise violated due process of law. Oral argument was a sine qua non to an understanding review of the record and a reasoned decision taking into consideration all relevent factors for or against these Petitioners. This because (1) the Commission itself -- not the hearing examiner -- made the initial or basic decision[10/] and (2) the members of the agency issuing the decision did not prepare or write it. If the Commission chooses to use what has been described as the " ' cold record rewrite expert ' "[11/] then it

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10/ As of August 1, 1964, the SEC joined the ranks of the large majority of agencies which allow their examiners to issue initial decisions, 17 C.F.R. §201.16(b).

11/ Beelar, The Dark Phase of Agency Litigation, 12 Adm. L. Bull. 34, 35 (Fall 1959): "One prime cause of delay at this [agency] review phase is the work of the 'cold record rewrite expert'. There is a tendency to do a complete rewrite job on the examiner's decision. Here is where the talent of the 'cold record rewrite expert' and Parkinson's First Law coincide to consume whatever time can be made available for the completion of this task. In this rewrite exercise the hearing record may be used not so much as a basis for arriving at a decision as to justify a decision otherwise previously made."

has a duty to see that at least those who hear oral argument decide. Any other procedure does not provide a "fair hearing", contrary to the findings of the decision below (Jt. App. 37). Oral argument is meaningless unless it extends to all Commissioners who vote.

IV. THE COMMISSION INCORRECTLY HELD THAT PETITIONERS HAD WILLFULLY VIOLATED THE SECURITIES EXCHANGE ACT FOR FAILURE TO STATE ANY ASCERTAINABLE OR REASONABLE STANDARD WITH RESPECT THERETO.

Respondent claims that Petitioners can be held to have acted "willfully" because they acted "intentionally" in the sense that they knew what they were doing and that there need be no intention to violate the law (Respondent's Brief, p. 32). This is nothing more than a rule which, under the law, distinguishes between a minor and an adult. In the former case, the law implies that the person isn't old enough to know the consequences of his act. In the latter case, the law implies that the person is old enough to know the consequences of his act. This distinction is hardly a basis for implying "willfulness" to the adult.

The standard sought to be enforced by the Commission in its decision below is no standard at all. See, "Annex to the Report of the Securities Committee", Section of Administrative Law, American Bar Association, 15 Adm. L. Rev. 188-192 (Summer 1963):

> "Under the statute broker-dealers registered with the Commission may be disciplined if they or those in their employ are, among other things, found guilty of 'willful' violations of the Securities Act and the Securities Exchange Act. Under the decisions of the Commission and the courts, the word 'willful' has little or no meaning and has virtually been eliminated from the statute. Acts or omissions which constitute a violation are deemed 'willful'. Knowledge that they constitute a violation or intent to violate is not required to be shown.

> "The public proceedings [against broker-dealers] are commonly instituted without prior notice to the respondents that the Commission will institute formal proceedings by press release announcing the order for hearing and a press conference at which the respondents are not present. The usual release will charge the broker-dealer with fraud and 'willful' violations. . . . So far as the public and the press can determine, the broker-dealer is charged with fraud. ***"

The Commission has failed, by rule or adjudication, to establish the criteria for "willfulness" which the law requires of an administrative agency in administering its substantive law. Compare the lack of standard used by the Commission with that recently enunciated by the Court in United States v. Peterson, 338 F. 2d 595, 598 (7th Cir. 1964) cert. denied, 33 U.S. L. Week 3286 (U.S. Mar. 2, 1965) (No. 771) (conviction for willfully attempting to evade payment of personal income tax):

> "The district judge stated that the criteria of willfulness which he applied is delineated in United States v. Martell, 199 F. 2d 670 (3d Cir. 1952). In that case the court said that willfulness is a state of mind in which the taxpayer is fully aware of the tax obligation which he seeks to conceal; that willfulness requires an intentional, rather than an inadvertent, act or omission; and that willfulness is characterized by a specific intent to conceal, in contrast to a genuine misunderstanding of the law's requirements or a good faith belief that certain income is not taxable. We are in accord with this definition."

V. THE FAILURE OF THE COMMISSION TO ACCORD PETITIONERS PROCEDURAL DUE PROCESS RENDERS THE COMMISSION'S DECISION NULL AND VOID.

The thrust of Respondent's argument is that "Petitioners' objections to the Commission's order are based almost wholly on alleged procedural defects." (Respondent's Brief, p. 7) (Emphasis added) But it is axiomatic that the essence of justice is largely procedural.

> Mr. Justice Frankfurter: "The history of liberty has largely been the history of procedural safeguards." McNabb v. United States, 318 U.S. 332, 347.
>
> Mr. Justice Douglas: "It is not without significance that most of the provisions of the Bill of Rights are procedural. It is procedure that spells much of the difference between rule of law and rule by whim or caprice. Steadfast adherence to strict procedural safeguards is our main assurance that there will be equal justice under law." Joint Anti-Fascist Refugee Committee v. McGrath, 341 U.S. 123, 179 (concurring).
>
> Mr. Justice Jackson: "Procedural fairness and regularity are of the indispensable essence of liberty." Shaughnessy v. United States ex rel. Mezei, 345 U.S. 206, 224 (dissenting).

As this Court has stated, Amos Treat & Co., Inc. v. Securities and Exchange Commission, 113 App. D.C. 100, 107, 306 F.2d 260, 267 (1962):

> ". . . [A]n administrative hearing of such importance and vast potential consequences must be attended, not only with every element of fairness but with the very appearance of complete fairness. Only thus can the tribunal conducting a quasi-adjudicatory proceeding meet the basic requirements of due process."

The failure of the Commission to conclude its proceedings with "reasonable dispatch", to possess a validly constituted quorum, and to adjudicate pursuant to established criteria, denied petitioners due process of law and a fair hearing. The right to a fair hearing is one of the rudiments of fair play assured to every litigant by the due process clause of the Federal Constitution as a minimal requirement. Absent procedural and substantive due process, an administrative agency's order -- as here -- is invalid.

VI. CONCLUSION

This case presents to the Court a clear opportunity and necessity to prescribe much needed guidelines in the important field of administrative law administered by the Securities and Exchange Commission.

Affirmance of the agency's decision below would have seriously adverse consequences upon the thousands of organizations and individuals regulated thereby. Daily, the Commission hands down decisions utilizing the inchoate standard of willfullness which it applied to Petitioners in this case. Regulated brokerage houses, and their principals and employees, face the initiation and conduct of investigations and adjudications over a period of years, the result of which may be certain financial ruin -- as here -- regardless of the merits involved. A special office writes decisions for Commissioners who can only review a "cold" record and whose only real contact with the case comes on oral argument.

Aside from the errors committed by the Commission with respect to these Petitioners, the above conditions merit special and careful consideration of this case in the interests of the fair administration of justice before an important and powerful agency of the United States Government. Petitioners submit that the Commission's order below should be reversed.

Respectfully submitted,

Charles S. Rhyne
Courts Oulahan
Edward D. Coxen

Rhyne & Rhyne
400 Hill Building
839 17th Street, N. W.
Washington 6, D. C.

March 27, 1965

CERTIFICATE OF SERVICE

I hereby certify that I have this 27th day of March, 1965, served by first class mail, postage prepaid, copies of the foregoing Reply Brief on the following parties to this appeal and to the administrative proceedings before the Securities and Exchange Commission:

Mr. Alvin Willard
c/o McCoy & Willard
30 Federal Street
Boston, Massachusetts

Mr. William D. McCoy
c/o McCoy & Willard
30 Federal Street
Boston, Massachusetts

Walter P. North, Esquire
Assistant General Counsel
Securities and Exchange
Commission
Washington 25, D. C.

Joseph W. Kiernan, Esquire
Smith, Ristig & Smith
815 15th Street, N. W.
Washington, D. C. 20005
Counsel for McCoy & Willard

Miss Ester Antell
New York Regional Office
Securities and Exchange
Commission
23rd Floor, 225 Broadway
New York, New York 10007

Courts Oulahan

April 18, 1963

Mr. Orval Du Bois, Secretary
Securities & Exchange Commission
Washington 25, D. C.

Dear Mr. Du Bois:

I acknowledge your letter of April 11th. I also refer to my 'phone call to you on April 15th. I appreciate your valuable time given me. I informed you that I must get to work or lose my home to the Internal Revenue Department, also there are serious liabilities for me to meet.

I am writing without the aid of an attorney to save money, plus I believe know my situation better than any lawyer, and I desire to save time and legal details. At this time I apologize for Mr. Palmer's language to your lady attorney, Miss Antell. I'm sorry. As I explained I could not control him.

Referring further to yours and Mr. Loomis' letter, my problem does not involve the question of a "Statutory Bar" to my employment but does involve a "bar" as a practical matter.

I have been virtually"out of business" for some six or seven yenrs due to the pending proceedings and my desire to avoid any possible aggravation of the situation. About two years or more have passed since the hearings were concluded. My financial situation has gone down from a multi-millionaire to a point where I can't pay my bills, had to go out of business and could not get new capital because of the unresolved proceedings. I also owe a considerable income tax as a result of assessments from the good years of 1954 and 1955.

I have no alternative but to obtain employment in the business I know best - the securities business - dealing between banks, brokers, institutions and corporations.

In view of the above I feel that I have been punished for whatever violation I am accused of. However, I will offer the following in addition: A two year suspension from the time of the examiner's recommendations. I would then need a letter from the S. E. C. of no objection to my going to work for Hardy & Co. or any other member firm, under the supervision of their partners. Gearhart & Otis is for all practical purposes out of business, but I would agree to have their registration with-

drawn and would further agree to not appeal the S. E. C's. decision. All I want is to get myself in a position that the New York Stock Exchange will approve an application from Hardy & Co., or any other member firm.

After meeting with the Stock Exchange, it is my considered opinion that a revocation of my license would ban me forever for working for a member firm.

I am getting more and more in debt because of no income, so please give me quick action.

Very sincerely

Fred D. Gearhart

G:L

GEARHART & OTIS
INC.
74 TRINITY PLACE
NEW YORK 6, N. Y.

[illegible] NEW YORK

TEL. WHITEHALL 3[illegible]
TELETYPE N Y 1-576

March 14, 1963

Regional Director
Securities & Exchange Commission
225 Broadway
New York, N.Y.

Dear Sir:

I am endeavoring to get a position as trader for Hardy & Co., a Member firm. I have taken the New York Stock Exchange examination and passed it. I have also notified the Securities and Exchange Commission that my former firm-- Gearhart & Otis, Inc. is in liquidation. Our open contracts are being cleared by Schweickart & Co., a member firm.

As a trader and producer of business, I will be constantly under the supervision of the managing and other partners. I will specialize in getting business from other brokers, banks and dealers.

Hardy & Co. have filed with the New York Stock Exchange to have me approved for said position. The books of Gearhart & Otis have been examined by the New York Stock Exchange, and have also completed their investigation of me. To-date, they have not yet approved or disapproved my application.

The purpose of this letter is to request a letter from you (The Securities and Exchange Commission) that they have noobjection to me going with Hardy & Co., as outlined above.

It is most urgent that I get an immediate reply, as I am badly in need of a job to make a living.

Thanking you, I remain

Very truly yours,

Fred D. Gearhart, Jr.

B

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON 25, D.C.

DIVISION OF
TRADING AND EXCHANGES

March 20, 1963

Mr. Fred D. Gearhart, Jr.
Gearhart & Otis, Inc.
Trinity Place
New York 6, New York

Dear Mr. Gearhart:

This will confirm our conversation of yesterday with reference to your desire to be employed as a trader with Hardy & Co., a member firm of the New York Stock Exchange.

As you are well aware, Gearhart & Otis, Inc. is the subject of a broker-dealer revocation proceeding now pending before the Commission and in that proceeding, the question of your individual responsibility is also involved. While the hearing examiner has issued a recommended decision, the Commission decision has not as yet come down.

As I advised you, since the Commission has not yet reached a decision, there is no statutory bar to your employment by a member firm of the New York Stock Exchange or any other broker-dealer. On the other hand, of course, the Commission does not require any securities firm to employ any person, nor do we require the New York Stock Exchange to approve any person.

If the Commission decision is unfavorable to you, then a statutory bar to your employment by a broker-dealer may thereupon arise, and any problems thus presented would have to be dealt with in the light of the conclusions and opinion of the Commission.

Sincerely yours,

Philip A. Loomis, Jr.
Director

Fred D. Gearhart, Jr.
c/o Hardy & Co.
25 Broad Street
New York, N. Y.

C

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18, 817

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR. AND EDWARD V. OTIS,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION AND UNITED STATES OF AMERICA,

Respondents.

Petition For Rehearing

CHARLES S. RHYNE
COURTS OULAHAN
EDWARD D. COXEN
RHYNE & RHYNE
839 17th Street, N. W.
Washington, D. C. 20006

Attorneys for Petitioners

July 15, 1965

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18, 817

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR. AND EDWARD V. OTIS,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION AND UNITED STATES OF AMERICA,

Respondents.

Petition For Rehearing

The decision of the panel of this Court on June 30, 1965, involves matters of such importance and novelty to the regulated securities industry, under due process of administrative law, that, it is respectfully submitted, the Court should reconsider its decision and order further oral argument thereon.

I.

The rule of law laid down by the decision is, we submit, novel.

Under the doctrine of exhaustion of administrative remedies, a period of only five days in which to file a petition for review with an administrative agency will be enforced by the Court even though the agency involved took ten years to complete the proceeding and nearly three and one half years to reach its decision of more than forty pages involving a record of over 16,000 pages, the petitioner at the time of the agency decision being without effective counsel. Present counsel did not enter the case until well after the five-day period had expired.

Under the decision, the doctrine of exhaustion of administrative remedies becomes a principle of law which overrides even the Constitution. Under Section 25(a) of the Securities Exchange Act of 1934, "no objection to the order of the Commission shall be considered by the Court unless such objection shall have been urged before the Commission." Under the rules of the Commission in effect with respect to this respondent, the time for filing the petition for reconsideration was exactly five days.[1/] Despite this fact, the panel held that "since the issue of delay was not raised before the Commission, it may not be considered on review" (p. 4).

The panel recognized that the length of proceedings before administrative agencies "has become a matter of major concern to

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1/ SEC Rules of Practice, Rule 21(e); 17 C.F.R. §201.21(e): "Any petition for rehearing by the Commission shall be filed within 5 days after entry of the order complained of and shall clearly state the specific grounds and the specific matters upon which rehearing is sought."

the Courts" and presented "the temptation to weigh the necessity therefor and to assay the prejudice resulting therefrom" (p. 3). Had the panel considered the serious issue of delay involved in this proceeding, including the violation of Section 6(a) of the Administrative Procedure Act and the Fifth Amendment to the United States Constitution, we submit, it would have reversed the decision of the Commission.

However, because, without any formality, the petitioners did not raise the issue of excessive delay before the Commission issued its decision, the petitioners are forestalled from challenging that matter in a court of law. The effect of this rule applying literally a limitation of five days permitted under the agency rules is to enthrone the doctrine of exhaustion of administrative remedies as being superior to due process of law under the Constitution of the United States.

The rule of law applied to the facts of this case can be simply stated. Where,

1. The consolidated proceedings involving an investigation commenced more than ten years before the issuance of the Commission's final decision in June 1964.

2. The period of time from the start of the hearings to the date of the Commission's decision involved approximately 94 months, as compared with an average of 28.6 months for similar proceedings

before the Commission.

3. The period of time from the date when the record was closed to the issuance of the Hearing Examiner's recommended decision involved thirty months, as compared with an average of 3.3 months for similar Commission proceedings.

4. The period of time from the date when the recommended decision was issued to the date of the final decision by the Commission involved thirty five months, as compared with an average of 13.5 months for similar Commission proceedings.

5. At least one of the Petitioners, who was writing "without the aid of an attorney to save money" wrote to the Commission in March and April of 1963 complaining of the delay in the proceedings and pointed out that he had been virtually "out of business" for some six or seven years "due to the pending proceedings and my desire to avoid any possible aggravation of the situation" (Reply Brief, Exhibits A-C).

6. At the time the Commission's decision was issued in June of last year, Respondents were without effective legal representation (Reply Brief, p. 3, n. 4).

The delay in this proceeding not only violated Section 6(a) of the Administrative Procedure Act. It also violated the Respondents'

fundamental rights under the Fifth Amendment to the Constitution, which should assure them of expeditious and reasonable dispatch in the adjudication of matters before an administrative agency. The delay involved in this proceeding, with corresponding serious prejudice to Petitioners, was a violation of that fundamental right. That violation cannot and should not be overriden by provisions in Section 25(a) of the 1934 Act. Indeed, if the 1934 Act were read in the context of the facts of this case, the provisions requiring that questions be raised with the Commission under a five-day rule would be unconstitutional.

II.

Aside from their legal and actual inability to present the question to the Commission in the five-day period, Petitioners did not agree to the rendering of a decision by other than those members of the Securities and Exchange Commission then members of the agency in March 1962.

The denial of due process by requiring Petitioners to argue the illegality of the agency's decision below - because the decision was rendered by only two members of the Commission - is equally a denial of due process. Further, Petitioners respectfully submit that the decision is in error in stating that they waived any objection to the

decision being rendered by any Commissioner who was not then on the Commission at the time oral argument was heard.

The decision states (p. 6).

> "At that time Chairman Cary stated: 'It is proposed that any Commissioner at the time a decision is rendered in this case who has not disqualified himself may participate therein, with the understanding that if he was not present at this oral argument he will read the transcript of the argument. Is this agreeable to all counsel?' After being assured that no Commissioner would be expected to read the entire record in this case, petitioner's counsel answered, 'Yes, your honor'."

This summary of what happened at the oral argument is in error. What actually happened was as follows (Cert. Tr., Doc. No. 1099, pp. 1-4):

Commissioner Cary: "It is proposed that any Commissioner at the time a decision is rendered in this case who has not disqualified himself may participate therein, with the understanding that if he was not present at this oral argument, he will read the transcript. Is this agreeable to counsel?"

Mr. Kiernan: "It is agreeable to McCoy and Willard."

Miss Antell: "Yes".

Mr. Palmer: "I beg your Honor's pardon. Ordinarily, would that mean there would be four Commissioners sitting?"

Commissioner Cary: "That would mean in this particular case that, assuming all of us are still living, it would be decided by four Commissioners apart from Commissioner Woodside, who has disqualified himself". ***

Commissioner Cary: "Commissioner Frear, having read the record, will participate in the decision."

Mr. Palmer: "***I am satisfied to have the absent Commissioner read the record and see the exhibits and then join in with the others." ***

Commissioner Cary: "Upon your sitting down, may we assume that the Commissioner who is not present may participate in the case?"

Mr. Palmer: "Yes, your honor."

Even though the law may be, as claimed, that a new Commissioner can decide a case, the inordinate amount of time involved in the decision of this case - more than three and a half years - rendered the participation by such a Commissioner void and a denial of due process as a matter of law.

CONCLUSION

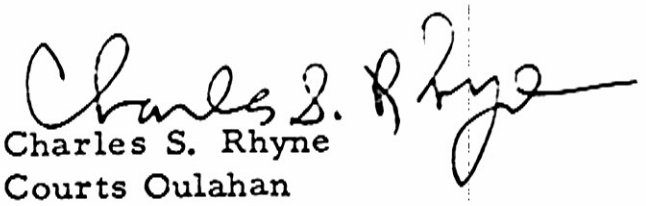
Thousands of persons and organizations are involved in the securities industry in the United States (Brief, p. 39). The rules laid down by the decision of this Court place them at the mercy of the Securities and Exchange Commission. But more than that, the rules laid down relate to all other administrative proceedings wherein a member of an industry may be threatened with the loss of his license and ability to do business.

Surely, members of a regulated industry deserve as much protection under the law as criminals and persons whose jobs and civil rights may be threatened by illegal or adverse action of governmental authority. In effect, the members of the securities industry become second class citizens under a rule of law which not only requires the

exhaustion of administrative remedies but which will have the practical effect of exhausting the respondents themselves.

Petitioners cannot believe that the panel, and this entire Court, will, upon further reflection, permit the decision rendered June 30, 1965 to stand. Through their counsel, they respectfully urge that, the matter be reargued.

Respectfully submitted,



Charles S. Rhyne
Courts Oulahan
Edward D. Coxen, Jr.
Rhyne & Rhyne
839 17th Street, N. W.
Washington, D. C. 20006

Attorneys for Petitioners

CERTIFICATE

I hereby certify that this Petition For Rehearing is presented in good faith and not for delay. The order of the Commission has not been stayed during appeal.

Charles S. Rhyne

Charles S. Rhyne

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18,817

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR. and EDWARD V. OTIS,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ANSWER TO PETITION FOR REHEARING

Philip A. Loomis, Jr.
General Counsel

Securities and Exchange Commission

Washington, D. C. 20549

July 20, 1965

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 18,817

GEARHART & OTIS, INC., FREDERICK D. GEARHART, JR. and EDWARD V. OTIS,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ANSWER TO PETITION FOR REHEARING

The petition for rehearing filed July 15, 1965 raises no question that was not carefully considered and correctly decided in the decision of this Court dated June 30, 1965.

Petitioners make the wholly unwarranted and incorrect contention that the opinion of June 30, 1965 holds that the question of undue delay can be raised before the Commission only by petition for rehearing after the Commission's decision. Actually, this particular objection, at that point might well come too late. Petitioners could have raised the issue of delay at any point when it appeared to them

that prejudicial delay was going to occur. See Deering Milliken, Inc. v. Johnston, 295 F. 2d 856 (C.A. 4, 1961); Texaco, Inc. v. F.T.C., 118 U. S. App. D. C. 366, 375, 336 F. 2d 754, 763 (1964), judgment vacated, ___ U. S. ___, 85 Sup. Ct. 1798 (June 7, 1965). In fact, petitioners' position with respect to delay in the Commission's proceeding was ambivalent. They wished the proceeding to be promptly terminated only if they could first be assured that such termination would be on a basis favorable to them. Since they were never able to obtain such assurance, they never objected to the delay until after the Commission's final decision went against them.

Petitioners' suggestion that Commissioner Owens' participation violated their constitutional rights is frivolous. As the opinion of the Court points out, and even aside from questions of waiver, [1/] and of failure to raise the objection by petition for rehearing, such participation, under the circumstances here present, conforms to the decisions of numerous courts and administrative agencies, and indeed to the practice of this Court.

For the foregoing reasons, the petition for rehearing should be denied.

Respectfully submitted,

Philip A. Loomis, Jr.
General Counsel

1/ Petitioners attack this Court's conclusion with respect to waiver by reference to carefully selected passages in the colloquy between former Chairman Cary and petitioners' former counsel at the oral argument before the Commission. The full transcript of that colloquy, as reproduced at pages 23 through 25 of our main brief, fully supports this Court's conclusion.